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EQUITY PRODUCTS OF THE 80's

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

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

MR. DANIEL A. CAMPBELL: This session is entitled EQUITY PRODUCTS OF THE 1980's. I hope that the title is not misleading. We are going to use the term equity products interchangeably with separate account based products and registered products. We hope to keep this session somewhat informal. Let me introduce our panel.

First we have Mr. Michael R. Tuohy, who represents the consulting side of the business. He is a Vice President with Tillinghast, Nelson and Warren in Atlanta.

Next we have Mr. Jack A. Marshal, representing the mutual viewpoint. He is a Vice President with John Hancock Variable Life in Boston.

On his right is Mr. J. Tyler Lee, representing the stock company viewpoint, who is an actuary with Life of Virginia.

As I said, we hope to keep this session somewhat informal today. We are going to split up the discussion into several segments, and we will try to have a few questions after each segment.

To get things started I would like to make a few remarks regarding why we are even talking about equity based products today. I would like to offer a few suggestions for you to think about.

First, there are various consumer considerations. There is a greater sophistication and awareness of consumers than ever before. Secondly, there is an interest in providing consumers with more choices and flexibility. And, thirdly, there has recently been some adverse publicity for the life insurance industry, specifically the FTC report. It may be viewed that the newer products are a way to offset some of that adverse publicity.

The next major area is competition that is taking place outside of the life insurance industry. There has been much success of other investment vehicles, such as money market funds. Secondly, there has been a number of marriages and mergers in the financial services areas between life insurance companies and other types of financial institutions.

Next is increasing competition within the life insurance industry. We now see increasing competition in the current generation of Universal Life products. One of the motivations behind the next generation of products is to stay one step ahead of the competition. There is also a realization that a lot of planning is needed to realize the benefits of new equity based products. If you are going to have these products to sell a few years down the road, you have to get started in thinking about the problems and concerns today.

There is an attempt to try to kill two birds with one stone in the regulatory arena. As most of you know, there has been some dissatisfaction with the regulatory environment in which we have to do business, specifically with the valuation and nonforfeiture laws. As people are now working on the new generation of products, there obviously is a need to revamp the laws for these products; and at the same time, hopefully, there will occur some revamping of the laws for current and traditional products as well.

Next, if there are some adverse tax rulings for the current products that are being marketed, then you may have to go to the next generation of products in order to get favorable tax treatment and a favorable rate of interest income for your policyholders.

And lastly, there has been a favorable impact and acceptance of some recent products, specifically with Universial Life, expanded markets for flexible annuities and the IRA products, and the recent successes of variable life.

Let me give you an outline as to how our remarks are going to be structured. First, we are going to talk about background information, including history of products within the U.S. and outside the U.S. and discussion of variable life products. Jack Marshall will be handling this, and Mike Tuohy will assist in the discussion of products outside the U.S.

The next major section will be current developments in the regulatory arena and some discussion of separate account based Universal Life. Tyler Lee from Life of Virginia will handle these areas.

The last major section will cover various concerns. First, Mike Tuohy will cover concerns regarding investment philosophy and financial reporting. Jack Marshall will discuss concerns regarding the impact on the distribution system and traditional products and also tax considerations. Finally, I will make a few remarks regarding the impact on computer systems and home office administration.

At this time, I would like to turn over the microphone to Jack Marshall who will give the remarks relating to background information, a history of products in the U.S. and variable life.

MR. JACK A. MARSHALL: In 1969, when I started working on variable life, there was a lot of optimism in the industry that within a year we would be selling variable life. Of course, it did not turn out that way. We fought the regulatory battles for four or five years and kept losing battle after battle. We were not even in a position to sell the product until about 1976. At that time, what we had was essentially two very restrictive legislative developments. One was Rule 62 of the FTC. Essentially it defined variable life contracts and what exemptions they would have. An important item was that it must have a guaranteed minimum death benefit and a few other things like assumption of mortality and investment risk by the insurers and a twenty-four month conversion to fixed life.

The states tried to regulate it, copied the federal regulations and what we ended up with was a restrictive model regulation that dictated lifetime coverage, level premium, a guaranteed minimum death benefit and a death benefit which was a multiple of the premiums paid. You had to credit the policy with the full amount within that year from the separate account.

The variable life that was developed was almost a perfect product. It was great for the agent because we paid the same high commissions as we do on fixed life. It was great for the company because we passed investment risks on to the buyer. The buyer got a current rate of return which is what he currently gets in the money market fund. Who can argue with a product like that? Variable life is currently being sold. It is actually very similar to traditional fixed whole life. There are fixed level premiums, guaranteed face amount of insurance as long as premiums are paid and very similar compensation patterns. Variable life differs from fixed life only in giving the buyer the flexibility of determining how his funds are invested and then automatically receiving the investment performance of those investments. There is no cash value guaranteed. The original face amount is guaranteed.

Our particular product gives the buyer who is willing to assume the investment risk the opportunity to make, in the quantities desired, either a stock fund or bond fund or a money market fund. Besides giving the buyer flexibility, this approach protects the seller from wide variations in product sales depending on what particular investment is popular at that time. For example, I think if the product had been offered in the mid 60's, probably 90% of the money would have gone into a stock fund. In the mid 70's common stocks were no longer popular, and most of the money would have floated into the bond fund. Today, with money market funds as the major attraction, 70% of the funds are being allocated to money market accounts, with the balance almost equally split between the bond and stock accounts. If some other investment became popular in five years from now, it is no great problem to add another account. In our case, we are modifying our system so that we have up to nine or ten different investment choices, although we do not currently have that number in the works, so we do not know what those other accounts are going to be.

Except for investment flexibility, variable life is probably even less flexible than traditional whole life since it has a very limited opportunity at the current time to adjust premiums by changing to a different plan of insurance. One of the questions often raised is why is variable life so saleable right now? In my opinion, variable life is attractive for the same reason that Universal Life is. The buyer yields a current higher rate of return on the savings portion of the policy. It is the same market force that has caused rapid switches of funds from traditional savings accounts to money market funds and money market certificates issued by savings and loan associations.

Further, variable life provides a vehicle to compete directly with term/ mutual fund combinations. The three major companies selling variable life now are having extremely good results with the sales. Equitable last year sold close to $40 million, and they are currently selling at close to a $50 million rate and maybe a little higher than that this year.

At the Hancock last year we sold a little under $10 million annualized premium. This year we expect to do somewhere between about $35 and $40 million. We are currently selling at about that rate, and the way it is going, we are not selling in all the states, and we still have a lot of agents to be registered. We will probably exceed that this year.

Monarch, their main sale, of course, is with Merrill Lynch. I have not heard their recent goals or what their performance is. They were looking for about $10 million in premium this year. The major current development was one of the competitors. Monarch just registered a single premium variable life. Up until now, everyone has stuck with the level premium, no variation type of policy. This policy has come up with a lump sum in the beginning. Of course, you can sell it in about half the states which have the model regulation which requires level premiums. They are trying to get it accepted in all the states. They are having some problems in some of the states.

Looking ahead, it seems clear that the concept of variable life and Universal Life are joined. A new product will be developed combining the premium flexibility of Universal and the investment flexibility of variable. You will hear more about this in a few moments.

MR. CAMPBELL: Mike Tuohy brings a little international flavor to our panel, and because of that, he is going to tell us what is taking place outside the United States.

MR. MICHAEL R. TUOHY: The purpose of this section of the presentation is more than just reviewing history of what has happened outside the U.S. but to analyze why it is going well in one country and going badly in another.

The four important countries that have tried to sell a variable life over the past twenty years are Holland, U.K., South Africa and Australia. Australia has only really been in it over the last two years. The first variable life policy, in fact, was sold in Holland in the late 1950's. It really was truly variable. Not only did the cash value and the face amount vary with the performance of the separate account, but so did the premiums. Later products in Holland did come out with level premiums. After this initial introduction in Holland, the main action shifted across the Channel to the U.K. A sleepy little company called London Edinburgh was the first one to introduce a separate account product over there, and they were sleepy in their marketing, and their sales volume was low. It is worthwhile just looking at the design of that product so that one can understand the evolution of at least the product design in the U.K.

The separate account was invested in a mutual fund which was out of control of London Edinburgh. Premiums were level as was the guaranteed death benefit. The actual death benefit increased by any increase in the value of the separate account. The more common version of the plan was an endowment, although there was a whole life version. Cash values were not guaranteed and varied with the performance of the separate account according to a fairly complicated formula. Even that formula was not guaranteed.

One important aspect of the product was that the company kept the investment income coming out of the mutual fund, and only the capital growth was passed on to the policyholder. Clearly, this can lead to a conflict of interest. In this case, the investments were out of the control of the life company. With later products the investments were in control of the life company. Clearly, it was in the life company's interest to invest in high yielding equities and in the policyholder's interest to invest in low yielding equities. Because of this conflict, Abbey Life introduced a participating version of the product, and they were fairly successful selling this product during the 1960's and one of the market leaders selling both through a direct sales organization and independent general agents.

Had I categorized both of these products, I might disagree with Jack that his is not quite the perfect product. It is very difficult for the policyholder to understand what is going on. They are sort of actuarially constructed products rather than constructed to try and let the policyholder see how his investment is growing and how he has invested. It is interesting that the biggest success in the 1960's, although it is beginning to be forgotten, was International Life. They sold a very simple product. It was a straight ten year endowment. A defined portion of each premium went into the separate account and that separate account just rolled up and cash value equaled the units in that separate account. There was a level death benefit, and both investment income and capital growth accrued to the separate account; and after the deduction of the management fee, it accrued to the policyholder. The amount being allocated to the separate account each year was fully defined. The method of calculating cash values was apparent to the policyholder.

The other development in the 70's is that we have seen the introduction of a partial Universal variable product. In the U.K. there are considerable tax breaks for the life insurance policyholder. One has to obey a few rules like pay premiums for ten years and that sort of thing. The full flexibility of Universal Life is not being offered there, but they offer as much flexibility as you can and still live within the tax rules.

One lesson from the U.K. is that simplicity of product helps. The other more important one, and Jack has touched on this in his section, is having an availability of choice of investment media. In the early 60's, all separate accounts in the U.K. were equity funds. Late in 1967, Abbey Life introduced the first major real estate fund, and several others soon followed. If this had not happened, maybe variable life would be a dead cause now in the U.K. because the equity market crashed soon after. The sales of equity based products drifted sharply downward. Because there were these real estate products, the sales force continued sales and just shifted the emphasis to real estate sales.

In the early 70's, fixed interest and money market funds were introduced, so when both the equity and the real estate markets went on a down turn, they were able to move into the money market fund similar to what was happening over here. In fact, things were getting rather carried away in the early 70's. Fortunately, some regulations came out, and they were restrictive and allowed the investments to be restricted to real estate, stock exchange securities and money market instruments. The commodity fund would have made some sort of sense, but the others were too restrictive.

Who did it in the market in the U.K.? Basically, there were a lot of middle companies, some of them linked to mutual fund organizations, that started out in the early 60's. Generally, it is these companies that still dominate variable life sales now. There are several very large companies, but the market leaders in variable life are generally those that really got off the ground in the 60's and 70's. The more established companies did not get into the game until at least the middle 1970's. A few got in earlier, but most of them turned a blind eye to it until basically it was too late. Now, in 1982, one finds that nearly all companies now offer variable life products. There have been several impressive successes among those little companies.

As far as the market share in the U.K. is concerned, variable life now probably accounts for one-third of all new individual life premiums, that is, annual premiums; two-thirds of single premiums and probably two-thirds of individual pension premiums.

I will briefly touch on the other countries. Holland started it all off. But in fact, the variable life has now virtually disappeared in that country. The principal reason was that they never got out of linking it to equity funds. They were not allowed to introduce a real estate fund. I think they were allowed to introduce fixed interest, but no one really got around to it, and basically, sales declined as the equity market crashed at the end of the 60's. It has never come back.

South Africa is the other successful market. It followed a similar pattern of the U.K. They have been allowed to introduce real estate funds, fixed interest funds and also one other concept that I missed when describing the U.K., the managed fund, where instead of the policyholder having the choice of investing in real estate, equity, fixed interest, money market, the choice is given to the investment manager so that the company itself can switch within this managed fund between real estate, equity and fixed interest as they see fit. There has been a success in South Africa.

MR. SEAMUS CREEDON: I would like to include in this discussion some of the concerns regarding variable life business which remain unresolved in the United Kingdom context under three headings.

First, the area of tax. Our fiscal authorities do not recognize the existence of separate variable life accounts in the tax computation of a life company. This creates problems in that a transaction may have different tax effects at the separate account level and at the corporate level. If you identify a transaction which makes sense for the separate account but has adverse effects at the corporate level, you have a real conflict of interest problem.

Secondly, there is the problem of liquidity. Particularly for real estate funds, it may simply not be possible to liquidate holdings in a short space of time to meet unforeseen needs, especially in a depressed economic situation. Most United Kingdom companies, therefore, give themselves the right to delay payments from real estate funds by up to one year. Although prudent liquidity margins and this right of moratorium do much to allay the problem, I do not think we will ever find a watertight solution to the liquidity issue.

Finally, in addition to these inherent problems, there is one we have created for ourselves. One of the areas of competition between United

Kingdom offices has been in the provision of generous low cost switching facilities. The effect of this has been to encourage smart operators who regularly switch funds to take advantage of very short term relative price movements. They might be in equities one week, cash the next, and real estate the week after that. These people can improve performance for themselves and their clients at the expense of the generality of policyholders, and I know many actuaries now regret the Frankenstein monster we have created.

I would like to enlarge a little on Mike Tuohy's remarks on the history of the development of variable life insurance. Mike mentioned the increasing acceptance of unit-linked life assurance in the United Kingdom, and it is true that many of the more conservative life assurance companies, including for example, the old, established Scottish offices, have moved into this field within the last two years or so. The point I would like to emphasize is that the entry of these companies has had the effect not of hurting those companies traditionally in the variable life market but of increasing the proportion of life assurance business which is written on a unit-linked basis.

As regards the investment mix of U.K. variable life insurance, I would estimate that around 50% of these funds are ultimately destined for investment in real estate, either through pure real estate funds or through mixed funds which have a real estate content.

Secondly, I would like to add to Mike's list of countries in which variable life insurance is available a fifth - the Republic of Ireland. We in Ireland believe that a greater proportion of our business is conducted on a variable life basis than in any other jurisdiction in the world; some 60% to 70% of individual business is of the unit-linked type. In Ireland the investment of unit-linked funds is even more dominated by real estate than in the United Kingdom in that about two-thirds of the funds are destined for real estate investment. The reasons are because of the particular stage of development of the Irish economy and because of the limitations of the local stock market. I think the reason for the success of variable life in Ireland reflects the particularly high rates of inflation in our country. In a time of high inflation, our policyholders are anxious to have their funds invested directly in media which at least stands a chance of keeping up with inflation.

MR. CAMPBELL: Tyler Lee will discuss the current developments in the area of separate account based Universal Life.

MR. J. TYLER LEE: I am going to try to take a few minutes this morning to bring everyone up to date on developments within the industry which seem somewhat obscure at this point in time but, nevertheless, what I consider highly innovative to the variable life insurance policy. It is called either Universal Life Phase II or Flexible Premium Registered Life Insurance, depending on whether you are talking to someone from the Sutherland, Asbill, and Brennan (SAB) Group or members of the ACLI Task Force.

I am going to be assuming, I hope it is a good assumption, that every true-blooded actuary here today has gone to at least one Tillinghast, Nelson and Warren Universal Life Seminar or has read a randomly selected issue of The National Underwriter in the past twelve months and so needs no introduction to Universal Life as it is sold today. When the SAB Group began meeting late last year, this consortium of represenitives from twenty-seven companies generally agreed that changes should be made in regulations at both the state and federal level in order to make them general enough to allow a policy with the following general design criteria:

o policyholder flexibility in amount and timing of premium payment

o policyholder flexibility in selection of death benefit schedule

o policyholder flexibility in changing either up or down the amount of insurance under the policy

o policyholder flexibility in selection of the corridor amount or minimal amount at risk within limits established by the insurer

o multiple investment options

o little or no guarantees with respect to death benefit, surrender values and perhaps even expense and asset charges

o no policy loan requirement if partial withdrawal right is present in the policy

This admittedly aggressive goal was pursued by first addressing the problem areas in the current NAIC Variable Life Insurance Model regulations. A lot of work in this area had already been done by an NAIC Task Force headed by Jerry Golden, President of Monarch Resources, Inc. Since change in the Model regulations was evidently already in the minds of state regulators, this seemed an appropriate first step. They were shooting for the rather optimistic goal of having NAIC pass revised model regulations some time at or before their December, 1982 meeting.

I am not going to take up the time this morning to go through all the proposed changes because they are rather extensive, but I do want to mention some of what I consider to be the most important or at least the most visible ones. Let me mention first, however, one overriding fact that justified, in our minds anyway, the vast majority of revisions and that is the fact that the FTC did not decide to exempt variable life insurance from federal regulations. Therefore, the severe product restrictions in the current regulations and duplications of regulatory provisions imposed by the FTC have become either unnecessary or redundant. So, we had a proposed regulation that first of all now makes a distinction between scheduled premium policies and flexible premium policies. The level premium lifetime coverage requirements that Jack mentioned have been deleted. Also deleted were the minimum multiples which define a relationship between death benefits and gross premiums and the cash value adjustment provisions. This latter provision is also a form of regulation and requires increments to cash values if the gross premium charge exceeds that shown in a rather conservative table.

Article VI, Section 7 of the regulation, for those of you who happen to have it here with you, charges against separate accounts is what it covers, received a major facelift when maximum charges for investment management expense and mortality and expense guarantees were removed. To counter opposition to this action, wording was added to require that all charges made against the separate account be disclosed in the insured's policy. To take into account the unique structure of the Universal Life type policies, Article IX, which covers reports to policyholders, was extensively modified also. The modifications here were based on the reporting requirements now in effect in many states for non-separate account based Universal Life and include a requirement for an Annual Report showing a reconciliation of the change in cash value during the previous year as well as the projected cash value as of the next report date.

Perhaps one of the more controversial changes deals with the concept of minimum or guaranteed death benefits. Under current variable life insurance policies, whole life coverage must be provided, premiums are set accordingly, and the policies must remain in force even if cash values go to zero because of less than adequate separate account experience as long as premiums are "duly paid". Universal Life, of course, has no fixed premium requirement and in essence guarantees coverage not as long as premiums are duly paid but rather as long as the cash value is sufficient to cover charges until the next policy processing date. In the event of an insufficient cash value, a grace period of at least sixty-one days will be required by the proposed regulation to give the policyholder a chance to remit another premium to maintain the policy in force. Non-Universal Lifers claim some guarantee is needed. Universal Lifers ask what do you want? No flexibility and the protection/savings mix reverting back to the century old concept of plan of insurance? Non-Universal Lifers come back - at least with present day Universal Life you give a guaranteed minimum interest rate. The policyholder knows at issue when his policy expires on a guaranteed basis if he pays planned premiums as scheduled. Universal Lifers come back - you are right to some degree. However, if the guaranteed values shown in the policy are not based on the actual mode of planned premium or if the premiums are not paid precisely on the first day of each payment period, even these values can give false comfort. I am sure this controversy will continue for awhile because what we are dealing with here, in my opinion, is basically a matter of degree. How much mortality guarantee or combination of guarantee and reports disclosure is enough? I have no doubt that some program acceptable to both sides will be reached fairly soon.

All these proposed changes I have just mentioned were echoed by the ACLI Task Force on flexible premium registered life insurance which just last month submitted a proposed variable life insurance model regulation to the ACLI's SEC Committee for approval. On March 10 that Committee did approve in substance the revisions submitted. Although, as I said, there are still some changes that are not yet finalized, chances do look good this time of getting a model regulation introduced to the NAIC in June and getting it up for a vote at their December meeting.

I wish I could talk as optimistically about the federal regulations work already started by the SEC group and soon to be started by the ACLI Task Force.

While some problems seem to be easier at the federal level, for example the definition of variable life insurance is much less restrictive there, most areas seem to be found, at this point anyway, that they are between the proverbial rock and a hard place. Just look at Rule 62, for example, which exempts Variable Life Insurance from some provisions of the 1940 Act. There you find the definition of and limitations on a term called sales load. Variable life insurance companies through the years have come to an agreement with the SEC on this aspect of their product. Their products, of course, could live within the loading restrictions and so could probably any traditional form of life insurance sold today. But, in trying to accommodate today's more flexible forms, one encounters several problems. For one thing, sales load is limited on a practical basis with 30% in the first year. Universal Life policies, like Life of Virginia's anyway, that are designed to more closely match revenue and expenses would have trouble with this if commission is paid at a 40% or 50% rate. Furthermore, sales load definition itself is in terms of premium payments. No premiums paid, no sales load. Couple that with the requirement that sales load cannot increase as a percentage from one year to the next. You begin to see the problem that flexible premium adjustable benefit policies would have under existing laws.

A lot of work remains to be done in the federal regulations area. As of right now, there is not even a concensus of how to approach the problem. Should 62 be left alone since those selling variable life insurance today can live within its restrictions? Can a new 62 be hashed out for the new flexible premium product, or should we revise 62 such as we have done with the variable life insurance model regulation to accommodate both scheduled and flexible premium paying products?

The first approach seems to be endorsed by the current variable life insurance companies and others who know first-hand what it is like to hold discussions with the SEC. Understandably, they want to take a more conservative approach. They realize that today's SEC staff is different from what it was when 62 was formulated. As the SEC itself put it, they have no institutional memory. Revising 62 could well mean another multi-year struggle. On the other hand, the other group, composed mainly of Universial Life writers, would like to take the second more aggressive approach. Perhaps they have been bolstered by the relative ease with which the current Universal Life policies have been accepted by the state insurance departments or perhaps they are just aggressive by nature . Anyway, again, I am confident that some compromise will be reached, but, and this is a big but, it could very well be a long way off.

MR. CAMPBELL: Next, we are going to talk about some areas of concern - what you have to worry about if you are going to indeed go forward with some of these products. First of all, Mike is going to talk about investment philosophy and financial reporting impacts.

MR. TUOHY: Investment philosophy is not really an area of concern. It is an area of lack of concern. One has not got the restrictions of having to match fixed interest liabilities as one has with a conventional policy. All one has to do is basically invest in the assets of the separate account along the lines as layed out in the prospectus. The only investment risk is one previously discussed.

One can make investment losses if a policyholder dies and one has to pay out the guaranteed face amount when one's separate account has not earned the stipulated 4-1/2% or whatever is built into the product. Other than that, there are no investment risks for the insurance company. Even if you had wholesale surrenders, you could cash in the assets of the separate account and pay the market value to the policyholder. Also, and a very big plus about the product that has not come out, one gets around the loan problem. Loans are effectively treated as withdrawals from the separate account, so if you take a loan on your variable life policy, the money comes out of the separate account and that part of the cash value that is loaned will accumulate at a guaranteed rate of interest, generally something like 1 to

1-1/2% less than the loan interest paid by the policyholder. This is a very big plus from these sort of contracts. Also, a big plus over Universal Life. Universal Life does half the job, and it effectively gets rid of the loan problem, but it does not get rid of the investment risk from surrenders. Investments are not a concern.

The second part that I want to talk about in this section is how one GAAP's a variable life policy. In the U.S., neither Hancock nor Equitable does reporting under GAAP, Monarch is the only one, and they use the same procedures as going on in the U.K. as far as their 1981 reporting is concerned. What happens is that you treat the deferred acquisition cost just like anything else. You set up your asset and amortize it just as for a traditional policy. On the benefit reserve side, you split it into two reserves - one called a unit reserve and the other a dollar reserve. What you look at is purely the cash transactions. In cash transactions, your income is premiums, and in addition to that, you get in cash the management fee that you are charging the separate account - the management fee in excess of any investment expenses. Income is premiums, and this management fee is your stream of income. Your principal item of outgo is, in fact, the allocations to the separate account. So you have a cash outgo every time you buy units in the separate account. The other items of outgo are the excess of any death benefits over the value of the separate account and also any differences in the surrender value that is paid in the value of the separate account at the time. Basically, you have these two streams of income and outgo. You sold for a net premium and build up a reserve in the normal fashion. This has the effect of creating level earnings, assuming all those assumptions come out properly.

The method is fairly well accepted. You will find it written up in the Ernst and Whinney GAAP book.

MR. MARSHALL: I am going to cover a few topics mainly dealing with tax considerations and then some of the impacts on the distribution system and what it is doing, in particular variable life to traditional policy sales. In the tax area, until recently at least, the variable companies felt we had a pretty secure favorable tax status. We have received a revenue ruling declaring that the policyholder would not be treated as though he had received the funds or the increases in amounts. It was taxed just like a fixed policy. From the company point of view, the Hancock had a private ruling where we went down to the IRS and asserted that the increases in the separate account were directly transferrable into reserve increases. They recognized this, and we are assuming that we just take a full deduction for any increase or decrease in the reserve.

Recently, of course, with the rapid rise in interest, if not sales, of the Universal companies in particular and the current tax problems of the Internal Revenue Service and the government trying to raise taxes, a proposal was made on excess interest which would essentially apply to Universal type policies which said that essentially 80% or 87-1/2% of the excess interest above a guaranteed rate would be treated as a dividend.

That was not quite as good as what the variable companies felt they had, which is 100% deduction. Then, all of a sudden it appeared that the idea was that this ruling would apply to the variable companies, also the variable policies. We do not have any guaranteed interest. There is a declared in effect or an assumed interest rate which was used to establish what reserve per $1,000 would be, but it is certainly no guaranteed interest. It is very unclear how you would apply the yield above a guaranteed rate. There is no guaranteed rate. Right now that is a problem that we are worried about. I think the companies' position right now is that this just does not apply to variable life. I am not sure that that is going to hold. We have some real problems in that area.

The major impact on the distribution system has been that sales are either flat or down a little. What we are finding is that variable life is making up the difference. The sales are continuing. The agents do not seem to be having the problems selling the product that they obviously are having on the fixed side. I did a study recently to try to ascertain what percent of variable life sales were just a replacement or a substitution for fixed policies. The way it came out was that approximately 70% of our variable life sales were new sales and that about 30% appeared to be somewhat of a substitution for fixed policies. Obviously, all our agents are talking about is variable life, and it will undoubtedly become a much more significant factor in replacing or substituting for our fixed policies in the future. I would expect that we would probably hit the two-thirds level within a couple of years of total sales. Currently, we are running somewhere between 30% and 40% of issue.

The big impact on the agent has been that he is now regulated at the federal level as a registered representative. What we are finding, of course, is that a lot of our agents have not been licensed, and unfortunately, it appears that a lot of them will never be licensed. If you are going to lead in the variable life area, you are going to need a more sophisticated agency force. This seems quite clear. The agent finds that once he sells a variable policy or is in the act of selling it, he has to be somewhat of an investment advisor. The policyholder more often than not says, "Where should I put the money?" We have three funds, M.O.N.Y. has five, Equitable has two, and all of us are planning more. The agent really does not know where to put the money. Right now, I think they are saying, "Put it in the money market." So the agent finds that he has to be more aware of what investments are, the whereabouts of the investments environment. The agent loves the product, of course, as it is currently constituted because of the high commissions. He is replacing term and vastly different products or approaches with this full commission investment approach. So the agents are very happy at the moment with the compensation elements. But, I think as we merge, as we undoubtedly will with the Universal type approach, the commissions will be forced down on a gradual basis. That seems quite clear.

We are also finding that we are getting a lot more interest in dual registration. We are getting a lot of queries from other companies' agents who want to sell variable life where there are not many companies selling currently or are not selling so well. We are getting a lot of requests to dually license other agents. We are starting to interest the brokerage community as being a viable product for the security area. The environment that the agent is in with the NASD rules where they are very restricted as to how they can sell the product, we have to clear all the sales material with the NASD, the agent must follow a very well-defined approach as far as having a prospectus and is very limited in the way he can sell the product. I think we are going to have some real problems in this area. We are already noticing a tremendous interest by the NASD and FCC in the violations. I think this is going to mushroom especially, as I am sure they are, if it is sold on the basis of high yields. If, in fact, those yields go down, I think we are going to have some real cans of worms to deal with.

This is an area where, in our company, we try to be very strict with the agents as far as following the procedures.

Another area where we have had real problems is just in licensing. On our traditional policies, many of the states were somewhat lax as far as being a licensed agent. You just cannot be that way with a variable product. The agent has to have the NASD license, and this is another real major problem for us.

MR. CAMPBELL: There is one area that is frequently overlooked in any discussion like this. You will see much discussion of impact on field force and even discussion of impact on policyholders but usually no discussion at all about impact within the Home Office on the administrative areas, on the computer systems, and on the organization.

Mike has already said that, from a company standpoint, there really is not an investment concern. However, from a competitive standpoint, I think there has to be a concern. With this type product, part of your success in marketing is going to be your historic performance on the fund administration - how well the fund has performed. From that standpoint, you are going to need a lot of expertise in the investment area for investment administration. For a larger company, this may not be a problem because that investment expertise is probably already there, but for a small to medium sized company, it has the implication that these companies may have to go outside for investment expertise or else they are going to have to develop a whole lot more investment expertise within the organization.

Another area of the company that is impacted significantly in the long run is policyholder service. Jack as alluded to the fact that the field force is going to require a lot of education and training. It is going to take a higher level of skills and more sophistication on the part of the field force to be able to successfully market these products. The same thing applies within the Home Office, especially to the people in the policyholder service area who deal directly with agents, brokers and clients on these products.

There are two approaches that you can take. One is to set up a subsidiary or separate department within the organization to handle the administration of these products.

If you do that, however, you will have to take some of your more experienced people from existing areas to move over to be trained in the new concepts and how to deal with the sophisticated agents who will be selling these products and the clients who will be buying these products.

Another possibility is to have just one administrative organization that handles all the products and product variations that are dealt with in the marketplace. If you take this approach, you have to have people in your administrative areas with enough background, training, and skills who can cover the entire spectrum of products all the way from traditional insurance products through the current generation of Universal Life, flexible annuities, and retired lives reserve products, all the way to the new registered type policies or separate account based policies.

Finally, I want to talk about the data processing area because there are going to be some substantial impacts there. First of all, you end up in a vicious circle of considerations before you can even get to the point of getting a good computer system. To develop a system, whether it is from within or acquired from outside, you have to have fairly detailed specifications for what you need the system to do. However, before you can develop these specifications, you need to know what the details of the product design are going to be. However, before you know what the product design is going to be, you really need to know what the regulatory environment is. But the regulatory authorities want to know what products will be sold. So, it really is an awkward situation right now.

There are a few vendors that are starting to work on the software which will support separate account based processing for either variable life or Universal Life. I know of a couple, and I am sure that there are some other vendors that are just waiting in the wings to see if there is enough demand in the marketplace to justify this substantial investment on their part.

However, in the short run, the choices are going to be limited; there are not going to be many vendors that you can go to to get this kind of processing if you want to enter the market quickly or if your requirements are very unique. I know that, in the case of John Hancock, they spent several years developing a system inside because that was their only practical alternative. This may be the case for other companies that want to enter the market in the next few years.

Another thing that can result because of a limited number of choices is a fragmentation in your systems approach. You may have an in-house system already, and you do not feel that you have the expertise to develop the additional systems capabilities from within your organization, so you go outside to find a package from a vendor, and you end up with two systems instead of one. There is some fragmentation there that has an impact on your ability to administer these policies effectively and efficiently. There are additional training requirements that have to take place within your organization in order to be able to deal with multiple computer systems.

Ideally, you would like to have one overall individual administrative system that would handle the entire spectrum of products, all the way from traditional products through the new generation of products. But, there just are not many available options today that will allow you to do that.

In the short run, you end up with some stop-gap solutions in order to be able to do the marketing that your company wants to do. In the long run, however, that will have an impact. Ultimately, you will have to move away from that fragmented approach to an integrated approach. There will be some very definite costs and efforts involved in making the transition to the ultimate, efficient, integrated computer system you need to be competitive.

In summary, when you are making the decision to enter this market, one of the strong considerations needs to be what to do with your computer systems and administration. You have to realize that your choices might be limited, that you will have to do the best you can, but you need to have a long run objective in mind of where you would like to be with your computer systems and administration years down the road.