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UNIVERSAL LIFE

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1. Are there any new product design features?

2. What are the principal computer systems problems in the administration of Universal Life?

3. How will companies cope with the excess interest ruling? Will profit margins be reduced? Can reinsurance minimize the effect of the ruling?

4. Will the limitations on gross premium and amount at risk affect the marketing of Universal Life?

5. What are the prospects for early issue of Universal Life policies whose values are tied to the investment experience of separate accounts?

6. Are companies adjusting reserves per IRS Section 818(c)?

7. What minimum reserve and nonforfeiture standards are being established?

8. What is the premium persistency in the second and later policy years?

MR. RANDALL P. MIRE: What I'd like to do is talk about some of the current and projected sales results of the product, what's happening in the product design area and agent's compensation, how companies are pricing products and in particular the current Federal Income Tax effect on the product.

First of all, what are the current trends with respect to the sales of Universal Life? As most of you are aware, the slow movement to Universal Life has become a tidal wave. A recent survey indicated that there are now about 130 companies selling Universal Life and there are about 200 or more products currently on the market. When the first companies introduced Universal Life products, they were regarded by many as the product of small maverick stock life insurance companies like Hutton and First Penn Pacific, and the product was opposed by the larger establishment companies, especially the mutuals. As you know, now the large stock companies have swung over to Universal Life. Companies like Transamerica, the Travelers, Lincoln National and, in addition, the mutuals have broken ranks. Establishment giants, like John Hancock, Connecticut Mutual, New England Mutual, New York Life, Mutual of New York and even Mass Mutual have now introduced Universal Life products.

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Many actuaries and others have felt that the wide-spread resistance to Universal Life at the agents' level would prevent its wide-spread acceptance. I'm sure many of you have seen the recent LIMRA survey that came out late last year which shed some light on agents' attitudes toward UL. About one fourth of the NALU members who were surveyed felt that "whole life is on the way out" and fully one half of the PPGA's and brokers agreed. Of all the agents surveyed, only 12% expected "little acceptance of Universal Life". This survey is based on data that now is about twelve months old, and no doubt, these percentages have shifted even more favorably in the direction of Universal Life.

What have been the actual sales results for companies that have introduced the product? We made an estimate late last year that Universal Life would account for something like 10% of new premium and since that time, LIMRA has come out with their estimate which verified the 10% estimate. That is a pretty impressive market share for a product introduced only about three years ago. Keep in mind that this 10% was for all the sales during 1982, up from only 2% the year before. So that by year-end 1982, Universal Life probably represented something in excess of 15% of current new business and at this stage is even higher. Indeed, LIMRA is projecting something like 25% of new annualized premium to be written on Universal Life during 1983. The two original small maverick companies are rapidly becoming not so small and not so maverick. Hutton, the first company to introduce Universal, sold over $100 million in new premium during 1982, most of it on Universal Life. First Penn Pacific, now a Lincoln subsidiary, the second company to introduce the product, sold over $50 million of first year premium last year. Big companies, little companies, PPGA companies, career companies, even home service companies, and several companies that were formerly traditional life companies selling traditional products now are selling Universal Life, which represents something like 90% of their new business. And numerous companies have increased their sales by 50% to 100% or more after the introduction of the product.

TEFRA has also assisted Universal Life sales considerably and will continue to do so. As the Life of Virginia ads say, "Universal Life is the only product specifically approved by Congress."

I think it's clear in spite of the resistance that Universal Life is here to stay. The sales have been phenomenal, but stop-gap is going to increase sales even more. This is already happening, as we can see. So it is selling and will continue to sell.

What are the trends for the types of Universal Life sold? One trend we will talk about later is toward a multiplicity of Universal Life plans. But one particular type of Universal Life plan seems to be becoming the dominant form of Universal Life. This type of plan is often referred to as "target premium" Universal Life and is part of a continuing trend toward developing Universal Life products which are closer to traditional whole life policies in structure and in agent's compensation. This Universal Life product has a "target premium" which is typically somewhat more competitive than non-par whole life policies, and has loadings and commission structures that are comparable to those of traditional whole life. The development of these products is not a new trend; it started some time ago. But it is really mushrooming at this point. It's a short term trend which I expect to continue for a time, as more traditional life insurance companies begin to offer Universal Life.

Early examples of this type of product are E.F. Hutton's Value Plan, their second plan, and Occidental of North Carolina's Ultimate Life. The first product that Hutton and First Penn offered were modeled after the classic Universal Life described by Jim Anderson which had certain basic characteristics. The classic Universal Life was based on a three factor approach for both loads and commissions -- that is, per policy, per thousand or percentage of premium. The classic product had lower commissions than traditional permanent plans, especially on the savings element. And the classic Universal Life had effective commission rates which declined as policy size increased.

The "target premium" Universal Life differs from the classic product in several respects. First of all, commissions are expressed as a percentage of the target premium and typically are comparable to non-par whole life on a premium comparable to non-par whole life. So it might be something like 90% of $10 per thousand. Commission percentages are the same for all ages and all face amounts. And commission percentages generally are quite high, as I mentioned, perhaps in the range of 90%.

The "target premium" plan is currently the most popular Universal Life type policy being developed and it is expected that the trend toward developing this type of plan will continue. Why is this?

First of all, the plan has a simple commission structure, just like the whole life policy with which the agents are accumstomed. Secondly, it pays the higher commission rate that the traditional agent is familiar with. And as more traditional companies enter the Universal Life marketplace, this is sort of a middle-of-the-road approach. The companies can say that they have Universal Life but it has the high commissions with which the agent is familiar on traditional whole life plans.

Now in the long term (whether that's six months or six years), one might expect the trend back to the classic Universal Life with the three factor approach, having somewhat lower commissions, especially on savings, and commission rates that reduce by policy size. Basically, it is very difficult to analyze exactly what's happening with loads and commissions. But if one looks at the target premium whole life, it is clear that the load and the commission on the savings element involved is quite high, relative to alternative products being offered by other industries. In the long term, it is impossible to compete for savings dollars with very high front-end loads and high commissions on the pure savings element of the product. In addition, we are about the only industry that still doesn't recognize "cheaper by the dozen" and offer substantially discounted prices and compensation for larger type policies, which is a basic feature of classic Universal Life.

Another major trend in Universal Life is the multiplicity of products. For example, Life of Virginia now has at least six Universal Life products on the market. Why the multiplicity of products? One reason is to enable the life company to aim at particular markets.

There are two mistakes in judgement which the management of life companies often makes in not developing Universal Life products for different markets. The first mistake is that the company considers the difficulty in developing the original product and setting up the administrative system. They assume that the second policy is going to be just as difficult to develop and

administer, and consequently, the second product is not pursued. This generally is not true. The second product is usually considerably easier to develop based on the experience of the first and of course, one can generally use the same type of administrative system.

A second mistake is the rationale that developing multiple Universal Life products is unnecessary. The company looks at the Universal Life policy first developed, and says, "Now we've got the policy that will solve all of our needs forever, and we don't need any other Universal Life policy. We'll just use the same basic Universal Life policy for all markets." That doesn't work either. This is why one finds that many of the more sophisticated, innovative companies have now developed more than one Universal Life product for different markets.

What sort of markets are we talking about? We're talking about the direct sale market, salary savings market, pension market, where quite often a different product is required for each one. We're talking about products that differ by the income of the insured, say a product aimed at a $25,000 face amount as opposed to a $250,000 face amount; products that differ by type of underwriting -- guaranteed issued versus full underwriting; products that differ in their basic structure -- a last survivor Universal Life, a joint whole life, a single insured whole life; and of course as we discussed earlier, classic versus target premium Universal Life.

Commission rates -- what's happening there? Well, as I commented on target premium Universal Life, the short term trend in commissions seems to be towards simpler commissions and commissions at a higher level. In addition, there has been some experimentation with different elements of commission. One that has become fairly popular lately is compensation based on the savings element. This might be a percentage of the fund itself, a percentage of the total interest on the fund or a percentage of the excess interest on the fund. Other companies have begun paying commissions on the cost of insurance itself, like on the term insurance. I think Transamerica was the first company to start this. We're seeing a lot more compensation being paid in the form of persistency and production bonuses which was pretty much unheard of on the early Universal Life.

Another trend is toward lower cost of insurance rates or "mortality charges". As most of you are aware, the cost of insurance rates on Universal Life are typically quite high. It is not at all unusual to have cost of insurance rates which are higher than the gross premium for annual renewable term. One must remember that these cost of insurance rates are supposed to be net rates (loadings are covered elsewhere) whereas ART premiums are supposed to be gross rates designed to cover all expenses and commissions. These cost of insurance rates have started to drop. A number of companies have dropped their rates, some of them more than twice. We expect this decline in rates to continue. Hopefully they will not continue to the self-destructive level that was seen on annual renewable term.

Another trend is toward separate rates for smokers and nonsmokers. Clearly, all rational companies are going toward separate nonsmoker rates and there are only a few holdouts left. The difference between the smoker and nonsmoker rates is clearly increasing. At some point, smoker rates will be considered substandard. Once again, Transamerica was the leader in this field in declaring smokers to be substandard. A recent survey now has

indicated that something like 20% of the Universal Life policies involved smokers being considered substandard, whereas early in the game it was only a very few companies that did this.

Further trends on cost of insurance rates include banding of the cost of insurance rates. We've seen a number of companies institute a per policy charge by having higher cost of insurance rates for the first X thousand. In effect, this was an alternative to obtaining a policy fee through not crediting interest on the first $1,000 of fund. There was also a trend toward a wider distinction in charges between males and females, but now with the proposed unisex legislation, it's a bit hazy as to what will happen in this area. There has been some movement toward the use of the 1980 CSO, but actually very few companies are involved here.

One very ominous trend is a movement toward select and ultimate mortality charges on Universal Life, and this is one that hopefully will stop. We hope that the companies will not follow the same suicidal tendencies with Universal Life that they've followed with annual renewable term down the select and ultimate path. Universal Life has been promoted by a number of people as an alternative to the self-destructive practices that the industry has followed on annual renewable term, so hopefully we will not make the same mistake again.

What about loads? Loads typically follow commissions or vice versa. In the short term, there's a trend toward higher loads. In the long term we expect the trend to turn toward lower loads, especially on the savings element. There has also been the development of more Universal Life products with back-end surrender charges, and specifically no-load products with back-end surrender charges. A number of companies have surrender charges in the first year on excess interest. I'm referring to back-end surrender charges similar to those on flexible premium annuities where the surrender charges disappear over some extended period of time, anywhere from five to 25 years. This is still a minority practice in the industry today because there are major actuarial problems with back-end surrender charges. First of all, unless one goes to quite a bit of difficulty, it's fairly likely that as a practical matter, one must set up very large statutory reserves, which can lead to very substantial surplus strains. Secondly, it is less likely that one can obtain the 818(c)2 adjustment for reserves on Universal Life with back-end surrender charges than on another product that we'll discuss later. So there is an alternative for the companies that are interested in 818(c)2, and quite a few companies are interested. Thirdly, there are potential administrative problems with back-end surrender charges.

In a recent survey of a little over a hundred companies, about 20 of them now have some sort of back-end surrender load. At least four companies now have no-load, back-end surrender charge Universal Life policies.

Interest rate credits: Interest rates continue to be aggressively high. A survey of over a hundred companies, done a few months ago, indicated a median interest rate still in the 11% range. A quick survey done about a week ago of about a dozen companies still indicated a median interest rate in the 10.5% range.

The initial products credited no excess interest on the first $1,000 or some other amount, perhaps $500, as a device to obtain a hidden policy fee. There clearly is a trend away from this. There are other more clever ways to obtain the policy fee. It clearly is being attacked by consumers and

this practice seems to be rapidly diminishing. Once again, a recent survey indicated that about half of the products follow this practice, whereas almost all of the initial policies had this feature in the product.

Indexing: The prognosis for indexing is a bit more difficult to predict. The main reason for indexing was the dividend question and to a lesser degree, marketing and self-adjustment considerations. Indexing for dividend purposes now has less appeal since the potential tax under TEFRA is so small. Indexing may not work anyway and there may be other ways to avoid the tax. It is now estimated that about 20% of the products in the marketplace are indexed.

Internal replacement programs: This is not technically a product but it has been so closely associated with Universal Life that it's typically considered to be part of any Universal Life product. The vast majority of companies introducing Universal Life are introducing at the same time some sort of internal replacement program where they, in effect, pay a commission rate on the rollover of their own whole life policy into their Universal Life plan. From most of the work that we've seen done, on purely economic grounds, these programs do make sense. I think we will continue to see these programs frequently in the future.

Other products: Another Universal Life product in which we have seen a big surge of interest and which is expected to continue, at least over the short term, is a hybrid Universal Life product. It's been called "excess interest whole life", "vanishing premium", "irreplaceable life", "pseudo Universal Life" -- a wide variety of names. This product combines certain features of traditional whole life with the fund mechanics of Universal Life. Some of you might argue that it's not Universal Life, but basically the product has all the fund mechanics of Universal Life; it just lacks some of the product's flexibility. You might notice that the first Universal Life that was issued in the U.S. came from a company on the West Coast. The excess interest whole life also comes from the West Coast, so it looks like a lot of product innovation is coming from this area of the country.

Like traditional whole life policies, the product has fixed premiums, a fixed death benefit and minimum cash values identical to traditional whole life. The commission structure is easy to understand and at a high level like traditional whole life. However, unlike traditional whole life, the product has the fund mechanics of Universal Life, using the concepts of current cost of insurance rates and current deductions for current mortality charges. The product in its most popular form carries a very high premium per $1,000 like traditional par insurance, say $13 per $1,000 at age 35 and carries a very high commission structure, say in the 90% range. The product typically has no front-end load or a very low front-end load with very large back-end surrender charges. This leads to relatively low early net cash surrender values but very huge accumulations at the later durations. Most of the products have a vanishing premium option where after a certain period of time, like five or six years, the policy in effect becomes paid up, based on current assumptions. Examples are Executive Life's Irreplaceable and Transamerica's T-13.

Why is this product so popular and why will it continue to be popular? Like the target premium Universal Life, it is a halfway house for companies trying to attract the more traditional agents. They can say that they are not really selling Universal Life, but they still get all the advantages that

appeal to agents with Universal Life -- the high interest rates, current mortality charges, etc. It has a lot of appeal because of commissions. It carries very high commissions on a very high premium and it's very simple. An agent can easily understand 90% of $13 per thousand.

This product is much more likely to obtain the 818(c) adjustment, for technical reasons, than the corresponding Universal Life product with back-end surrender charges. This can be extremely important in pricing these products. I mentioned earlier that it's quite difficult to develop a Universal Life product with back-end surrender charges. One of the main appeals of this particular product is its use of back-end surrender charges. These surrender charges are important for two reasons. One is that they show extremely high 20th year or later accumulations, which a number of companies use in illustrating their products. And of course from a profitability point of view, the company is relatively isolated from huge losses on early lapses because of the high surrender charges involved.

This product will compete directly with the mutual companies' participating products. Indeed that's why it was designed. It is head-on competition to traditional, participating whole life policies sold on a vanishing premium basis and, at least on an illustrated basis, it compares quite favorably to a typical mutual company's product. It has great appeal to the agent because it pays an extremely high commission on the top premium rate just like the typical mutual companies do, unlike Universal Life -- even target premium Universal Life -- which typically cuts off the top commission at a lower level.

I think this product will have considerable short-term success, but if you take a hard look, what inherent advantage does excess interest whole life have over Universal Life that would assure it's long-term viability? Currently, it may have an advantage because of its eligibility for 818(c)2. However, this advantage, if it does exist, is not likely to last, especially with the impetus toward the level playing field concept in the Congress -- in particular, the possible elimination or substantial reduction of 818(c)2.

In addition, this hybrid product may currently require lower statutory reserves than comparable Universal Life products. However, this advantage, if it currently exists, is due to irrational valuation rules which, like the federal income tax advantage, is not likely to continue long term.

Probably the most important advantage this product has is that, to insurance agents and to traditional life insurance executives, it looks more like traditional whole life insurance. It gives them a warm feeling inside. However, you might compare these hybrid products to prop jets replacing propeller aircraft. People were more comfortable with the prop jet when they first saw it because it had that propeller out there that they were so used to. Once the agents and the insurance company executives are weaned over to a "prop jet" it is fairly easy to move them on to the obviously superior full jet aircraft.

We see companies moving from the prop jet "in-between" approach to the full jet aircraft in the long term, because the pseudo Universal Life product really has no inherent advantage over Universal Life. It really has several serious disadvantages. However, we do expect that this product will be extremely popular through the mid-1980's. I do have my doubts as to what the market share for this product will be in 1990.

Perhaps the brightest future of all is for a product that represents the marriage of the concepts of Universal Life and variable life. As most of you are no doubt aware, this is the "Variable Universal Life" concept, also called "second-generation Universal Life", "third-generation Universal Life", "son of Universal Life" and a wide variety of other names. It is a Universal Life product in structure, with the accumulating fund invested in say, stocks, bonds, money market funds or perhaps conceptually even real estate, and the insured bears all the capital risk, up or down. Products similar to this have been sold in the United Kingdom for example, for a number of years, and in a fairly short period of time now represent something like a third of the market in the U.K.

Right now, there are regulatory blocks to the product. There is a group of 25 companies commonly known as the "Sutherland Group" which is actively working on removing the regulatory blocks, and they expect to be selling this product soon. There are two major regulatory blocks. The first is the State Insurance Departments -- a model bill has been approved by the NAIC and it's expected to be passed by the States. The second is the SEC, where a model bill has been drafted.

Current trends in the pricing of Universal Life: Initially Universal life was priced with profit margins equal to or larger than traditional products. Currently in the work we see being done, the profit margins in pricing have dropped but are still at the level of traditional products.

Finally, just one note with respect to persistency on Universal Life. One of the reasons Universal Life was advocated was that its inherent structure was such that it was anticipated that the product would have better persistency than other products. And indeed the limited information that we've seen has indicated very good persistency on Universal Life.

In closing, I believe that the future health of the industry depends in a large part upon Universal Life and hybrid Universal Life products like excess interest whole life. Hopefully it will continue to be developed and sold in a responsible manner. If you look around at the spectrum of products and practices currently being offered in the industry, at one end of the spectrum you see the pure protection market. This is the ART, select and ultimate, graded premium whole life products. Here the industry has followed suicidal practices that are leading to losses for the direct writers, losses for the reinsurers, and insufficient income for the agency system. At the other end of the spectrum, where the pure savings products are being developed, you see single premium deferred annuities. There we see aggressive, reckless practices by a number of companies that could lead to major bankruptcies of life insurance companies of a magnitude unheard of in our modern era.

In the middle ground you still see companies clinging to traditional whole life, which is rapidly being rejected by both the public and our current distribution force. The one island of sanity and hope for us is Universal Life and interest sensitive products like Universal Life -- a good economic buy for the insured that makes a profit for the direct writing company and pays a living wage to the agent. I hope we will continue to develop and sell this product in the rational manner that we have so far.

MR. MICHAEL F. DAVLIN: My topic this morning is required cash surrender values for Universal Life products. A few of the questions I will address include:

- What is the status of NAIC activity in this area?
- What are the prospects of the NAIC adopting the current ACLI nonforfeiture proposal?
- As I personally do not believe that a verbatim adoption of the ACLI proposal is very likely, what objections may be addressed by the NAIC?
- In order to resolve these objections, I will propose a new definition of what constitutes an equitable cash surrender value for insurance issued through a stock company.

The responsibility for developing a Model Universal Life Insurance Regulation lies with the NAIC Life Insurance (A) Committee, which reports directly to the NAIC Executive Committee. The (A) Committee received approval from the Executive Committee to appoint a task force with a ten member industry advisory committee. This task force has the catchy name "(A) 5 Task Force on Universal Life and Other New Plans". Its industry advisory committee, the "(A) 5 Advisory Committee", has been very busy over the past months and is scheduled to deliver an initial draft proposal to the task force in June. This initial draft will be widely circulated in order to solicit a broad exposure and discussion within the industry.

What will the draft contain? According to the charge to the task force the regulation should address appropriate issues of regulatory concern, including the following:

1. The manner in which "universal life insurance" plans, as defined, may comply with the standard nonforfeiture and standard valuation laws or the equivalent thereof.
2. The manner in which "universal life insurance" plans and the companies issuing such plans may appropriately anticipate future liabilities to assure the financial integrity of such companies to the extent such anticipation differs from number one above.
3. Any mandatory or prohibited policy design features of such policies.
4. The manner in which prospective purchasers of such plans are fairly and accurately appraised of the nature of such plans and the manner in which existing policyholders under such plans are informed of the nature and status of their purchase.
5. Any other legitimate regulatory concerns affecting the fair and accurate development, marketing and distribution (including replacement) of such life insurance plans; the administration of such life insurance plans; and the reasonable assurance of the financial integrity of those companies issuing such plans.

According to Jim Jackson, Chairman of the Advisory Committee, the June draft should contain few surprises:

1. The cash value and reserve requirements will consist of the current edition of the ACLI guidelines.

2. The requirements for indexed policies will conform fairly closely to the current California bulletin.

3. At present, the committee has done little work in the area of mandatory/prohibited design features beyond listing current state requirements.

4. Nearly all companies' products comply with the intended periodic disclosure requirements.

5. The committee believes that advertising and solicitation regulations should be neither more nor less burdensome for Universal Life than for other products. They currently intend to simply refer to the latest NAIC proposed model law.

If the task force approves the June draft, it will be sent to the (A) Committee, then to the Executive Committee, then to the full Plenary Session. If approved by the Plenary Session, the draft will become a model law which would be sent on to the individual states for adoption.

What are the chances of that happening? Not very likely. The California Department, which has a good deal of influence in NAIC actuarial circles, has grave reservations about the cash value section of the ACLI proposal:

1. They have voiced the opinion that substandard cash values are too low, because the charges often exceed CSO rates.

2. Contrary to the ACLI proposal, they insist that mortality charges must be less than CSO rates. In fact, the department is developing smoker/nonsmoker rates for the 1958 CSO Table using the Society of Actuaries methodology used to derive smoker/nonsmoker rates for the 1980 CSO. In the future, nonsmoker mortality deductions on products issued under the 1976 Amendments will have to be less than these newly-derived nonsmoker rates if the plan is to pass muster with the Department.

3. They analyze each element of the account value separately (interest; expense loads; mortality guarantees) rather than viewing the cash value as a whole.

4. They object to the fact that the ACLI guideline does not place any limit on the amount of contingent interest that may be forfeited on surrender.

In a conversation I had last week with John Montgomery, Chief Actuary and Deputy Insurance Commissioner, California Department of Insurance, he mentioned that he intends to bring these topics to a head with other NAIC actuaries.

How valid are these concerns? Eighteen months ago, Shane Chalke and I wrote a lengthy paper which has just appeared in galley proof form. Our main motivation, beyond the usual desire for fame and riches, was to prove that the rate regulations and design limitations embodied in the retrospective view of Universal Life have absolutely no basis under current nonforfeiture law. The key to our proof was to bundle the product back up and to look at the guaranteed future benefits.

When we did this, we made some interesting discoveries. Perhaps the most important was that the role of the account value and mortality and interest guarantees is to define what the policy's guaranteed death and endowment benefits are at any time. These elements form what we called the cost structure of the policy: In order to obtain a certain pattern of guaranteed benefits, how much does the policyholder have to put in his account value? If a company decides to charge mortality rates twice those of 1980 CSO, a larger account value is required to generate a given pattern of guaranteed benefits than would be the case if the company charges 1980 CSO rates. In other words, one product would be more expensive than the other.

Given only the information on mortality charges, you cannot determine whether either policy would comply with the standard nonforfeiture law. To determine whether a product provides at least minimum cash values, you have to look at the present value of guaranteed benefits using the minimum standards of interest, mortality and expense factors under the nonforfeiture law. The contractual surrender value, if it is not less than this present value of guaranteed benefits, can be said to provide sufficient cash values under current law.

In my examples, one plan at twice CSO and the other at CSO (if we further assume that the contractual surrender value equals the account value and that the guaranteed interest rate on the account equals the maximum rate for nonforfeiture), we arrive at a counter-intuitive conclusion: The product with mortality charges twice those of 1980 CSO provides higher than minimum cash values, while the other merely provides minimum cash values.

Perhaps a rough analogy to conventional products would help to clarify this argument. Consider two nonparticipating whole life policies: one with a gross premium equal to the statutory nonforfeiture premium and the other with a premium twice that. If each policy provides a cash value equal to its historical asset share (assuming equal expenses), then the high cost policy will provide cash values above minimums. No one would argue that the high cost conventional product violates the nonforfeiture law because of its high premium level, and everyone would agree that it is tough to sell such a high cost product -- so why all the concern over Universal Life guarantees?

The answer appears to be that people still tend to think in terms of a special case demonstration of nonforfeiture compliance -- the retrospective "E.F. Hutton" proof. Taking the more general prospective view, one can see that the ACLI proposal correctly avoids placing any limits on mortality charges (although they did limit the expense loads). It follows that the California objections to substandard mortality charges, smoker/nonsmoker rates, and item by item analysis of account guarantees are off the mark. Placing limitations on these elements logically falls under rate regulation and not nonforfeiture compliance. I strongly urge each of you to do whatever you can to oppose this unjustifiable expansion of the regulatory domain.

What about their objection to unlimited forfeiture of contingent interest? Here I believe that under current law they are absolutely correct. The nonforfeiture law defines cash values in terms of the present value of benefits that would be provided assuming no forfeiture is made. It looks at benefits guaranteed to persisters. From the viewpoint of the nonforfeiture law, there is no such thing as contingent interest.

This does not mean that you cannot have a limited form of contingent interest. A prospective demonstration of nonforfeiture compliance enables the insurer to guarantee a lower rate of interest to the account value than is used to calculate nonforfeiture values. This creates a legitimate, cigar-shaped difference between the account value and the minimum cash surrender value. This "surrender charge" would disappear at maturity and, if carefully worded, could conceivably be defined in terms of contingent interest credits. This approach should overcome the California objection to unlimited forfeiture of excess interest credit.

To be fair about the retrospective ACLI proposal, I have to admit that there are significant drawbacks to prospective Universal Life cash values. For example, if the current guaranteed rate of interest is greater than the nonforfeiture interest rate, a net deposit of one dollar to the account value will increase the cash value by more than one dollar. Needless to say, this is a very marketable but unprofitable feature to build into a flexible premium product. This problem is not unique to Universal Life. Who is able to issue competitive single premium nonpar life when the initial cash value exceeds the gross premium? Universal Life, which can be viewed as a series of single premium purchases of deferred coverages, would have this problem in spades under a prospective standard.

Actually, the problem is not with the prospective standard as such. The problem lies with the fixed and arbitrary rates at which companies must buy back the benefits promised to the policyholder. This problem exists across the board for our non-registered life products and is the source of nearly all of our liquidity and replacement problems.

The solution does not lie in throwing out the prospective standard, nor in passing through the capital gains and losses on our assets as is done with variable life. What we need is the freedom to value our liabilities, our contractual promises, at market rates which reflect our true opportunity costs. To get to this point, we need to challenge some of the traditional thinking on nonforfeiture values, which has been primarily geared towards mutual company products and philosophy.

For example, why do we find actuarial definitions of equity that contain retrospective elements such as historical asset shares? If you personally were buying a used home, or used television set, or even an after-market bond, would you be swayed at all by what the seller claimed he paid for the item? I hope not! The only relevant question is what you feel the item will be worth to you or to others in the future. Bygones are just that -- bygones.

However, most actuaries would not feel justified in treating past premiums and other cash flows as just so much water under the bridge. Many actuaries have argued in favor of retrospective cash surrender values as evidenced by this quotation from the Guertin committee:

> "There appears to be no one fixed rule which should be followed in securing equity. Nonforfeiture benefits may be said to be equitable when they are established at such a level that the withdrawing policyholder will receive a benefit, be it cash or some form of continuing paid-up insurance, which will be as nearly as possible equivalent to his contribution to the funds of the company less the cost of the protection which he received and less the cost of introducing and maintaining him as a policyholder and which will not exceed the largest amount which can be paid to him without impairing the equities of the remaining policyholders of the company."

If I were an actuary working for a mutual company, I would agree with that passage. The "raison d'être" of a mutual company is the provision of insurance at cost, which implies an equitable claim to the historical asset share upon surrender. As a stock company actuary, I have three objections in principle to that formulation. The first, and most obvious, is that it fails to even mention the interest of the stockholders! Secondly, it implies that there exists a relationship between policyholders in a stock company. Lastly, and most important, is the fact that stock companies do not promise to provide insurance at cost. Therefore, I contend that any ideal framed in retrospective terms is totally inappropriate for stock companies. My ideal for a stock company can be expressed as follows:

> "A terminating policyholder should not leave the stockholders in a better, or worse, position than they would be if the policyholder remains inforce until death or maturity."

Following through the logical implications of this ideal, which I won't go into now, leads one to favor adopting the recent trial balloon of the Greeley Committee: require extended term insurance and reduced paid-up values, but no required cash surrender values. Returning to Universal Life, it is the ideal candidate for this approach. The policy essentially consists of extended insurance purchase guarantees, and reduced paid-up can be effected by simply reducing the face amount.

I am going to close by sharing an experience I once had that shaped my opinions on nonforfeiture laws. Perhaps some of you have seen the movie "Time After Time". In this movie, H.G. Wells invented a time machine in which he chased Jack the Ripper through the 20th century. Wells was able to stay one step ahead of Jack by traveling a few days into the future and purchasing a newspaper to see what Jack would do. Coincidentally, I once had a similar experience when I traveled to the 21st century and brought back an issue of the Wall Street Journal which I happen to have with me. Hmmm . . . "Ralph Nader, Father of the Modern Automobile, Dead at 135". This looks interesting!

Ralph Nader, known for his many achievements in the field of consumerism, was found dead today in his austere apartment, apparently from natural causes. Ralph first made his mark in his titillating expose of the General Motors Corvair in the 1960's. In the 1990's, Nader led the fight for the 10,000 mile free look. Of course, industry curmudgeons derided this trial period as a 10,000 mile free ride. Perhaps Mr. Nader will be best remembered as the prime force behind Congress passing the Fair Trade-In Act of 1991.

Few people today remember that in the 20th century there were no guaranteed trade-in values for automobiles. The individual who no longer needed his car had to cast his fate to a chaotic and unorganized used car market. Typically used cars were sold to speculators whose only interest was in turning the cars around at a profit. They were often sold at discount prices to car dealers who had an unfair bargaining advantage over the consumer.

Young Ralph, who never personally owned a car, once witnessed his elderly grandmother trade-in a car to a Los Angeles television personality who promised to stand on his head to make a deal. This sight so appalled Ralph that he vowed that some day he would do something to rectify this market failure. The rest is history.

Congress passed the Fair Trade-In Act for automobiles, and the industry response was sharp and predictable. They argued that "everything is just fine and peachy now and why fix something that isn't broken?" They further argued that people would only trade-in clunkers, and would hang on to good cars for as long as they could. It didn't take long for severe problems to develop.

In the mid-1990's, new, non-union companies, which had invested heavily in robotics, were able to produce new cars for a price less than the trade-in value of old cars. These upstarts mounted an aggressive marketing program which urged car buyers to trade-in their old cars, buy new ones, and invest the difference. This led to a dramatic drop in market share amongst established companies who complained that people were trading in perfectly good cars in exchange for vehicles that had not passed the test of time. However, this storm eventually abated as the older companies were able to upgrade their plants to utilize the new efficient production methods.

Nonetheless, trade-in prices were still too high in relationship to new car prices. Always optimistic, most companies continued to sell new cars in the vain hope that relatively few people would actually trade-in their cars. The most recent chapter in this story has been the introduction by a west coast company of a new automotive concept they call the Universal Auto.

The Universal Auto, also known as the Cosmic Car, comes in an inexpensive kit which can be purchased in parts as you need and can afford them. The proponents of the Universal Auto argue that the Fair Trade-In Act never anticipated that cars would be sold in kit form and therefore, the provisions of the act do not apply to their product. Old line Detroit manufacturers have strenuously objected to this logic. Their battle cries have been heard up and down the halls of Congress: "If it rolls, it's a car", and "Nine million auto workers say it's wrong".

Well, I'm going to stop here because the moral to my story is obvious: Laws that ignore economic reality create chaos, whether the field is automobiles or insurance.

MR. DALE W. HOTZE: Since the introduction of Universal Life in the 1970's, companies have struggled with the administration and automation of the product. Virtually all administrative areas are affected by Universal Life. Over these past few years we have heard of, or experienced, problems associated with the product. Most of the problems can be categorized into two

areas. One is the home office functional areas, and the second is the selection of application software from outside vendors. Therefore, the first part of our discussion will focus on specific Universal Life administrative problem areas. We will then discuss some general guidelines that have proven effective to assist in software selection.

Universal Life - Administration

Not since the beginning of the insurance industry has anything been as much discussed and debated as Universal Life. It seems that hardly a life insurance company exists today that hasn't seriously considered whether or not to enter the Universal Life arena. Whether it is for everyone -- company and consumer alike -- will forever be a question without an answer. There are, however, certain statements that can be made about Universal Life for which there is little disagreement. One of those is product administration.

As has been discussed many times, the factors that created the ground swell of interest in Universal Life include such things as:

- Fluctuating interest rates and inflation
- Continuing pressures from other insurance companies and the advent of full-service financial institutions
- The increasing vulnerability of replacements and growing policy loan balances
- The continued growth of high interest annuities and low rate term insurance

These factors, although not all inclusive reasons for the interest in Universal Life, are some of the very reasons that the product creates administrative problems for most companies.

Of course, the attractive concept of "flexibility" of Universal Life is what makes it appealing to everyone. It is this flexibility, however, that makes it one of the biggest administrative challenges the industry has ever faced. A look at some of these administrative challenges and how they differ from more traditional products will begin to highlight what is in store for the company considering Universal Life.

Proposal Services: Traditional life products generally have one or two variables at most. Many have fixed components. Take an ordinary life policy for example. The premiums are fixed, the death benefit is fixed, the interest rate credited to cash value is fixed -- a presale proposal is "a walk in the park". On the other hand, a Universal Life proposal could have variable premiums, variable death benefit, variable rates of interest crediting and any number of other problem areas such as expense loads, commissions, etc. Some might consider this also a walk in the park, but I suggest to you that it would probably be Central Park at midnight.

This is one of the areas of administration that some companies have overlooked in their initial approach to Universal Life. Most Universal Life sales to date, perhaps because of its uniqueness, have required multiple policy illustrations per sale. Many consumers are getting quotations from

two, three and (sometimes) four and five companies so the proposal turn-around pressures on the producer is great. Compounding the problem are the various state requirements for disclosures of replacement and interest crediting information. Needless to say, the proposal services for Universal Life are expensive and very important for the future success of any company considering Universal Life.

Commissions: Commissions for traditional products are almost always a percentage of first year premium with renewals for some period of time thereafter. Because Universal Life first year contributions have two principle components — pure insurance and cash value -- how are commissions calculated? There are many schools of thought on how this should be done. Some companies pay a percentage of the pure insurance premiums plus a lower percentage for cash value amounts not unlike that paid on single premium annuity contracts. Others use a portion of the expense loads to pay commissions. There are so many components that make up the premium dollar for Universal Life that commissioning becomes a very "creative opportunity" for the company.

Because Universal Life affords flexibility in the amount of insurance provided, an additional commission problem arises. If the initial contract calls for $100,000 of death benefit and the commission is paid accordingly, what happens if the policyholder elects to increase or decrease the insurance coverage? How are commissions calculated to address all of the elements of the policy that are subject to change? Most companies have addressed this problem by fixing their commission for the first year based on certain parameters. Generally speaking, there are some restraints on the flexibility allowed during the first year so that the policy can become more settled within the company's administrative network and commission structure.

An interesting question that has never been fully addressed is that of commission chargebacks. In traditional life insurance chargebacks are handled in the normal course of business. With Universal Life, however, the charging back of commissions takes on an added dimension of complexity. Since the pure insurance coverage and cash value contribution is subject to change throughout the first and subsequent years, commission recoveries are very difficult. Adding to this problem is the practice of performance bonuses that many companies offer on their traditional products. Because persistency is not guaranteed and coverages go up and down throughout any given year, such bonuses are very difficult to calculate. Many companies have eliminated bonuses on Universal Life commissions for this reason.

Premium Processing: Since there are two elements to the premium for Universal Life — pure insurance and cash value contributions -- the processing of premiums presents a particularly challenging dilemna. If a contract holder pays an initial premium and makes no changes throughout the year, a relatively easy application is possible. Where the problem exists is when changes in coverage are made early in the first year. If inadequate premiums have been allocated for the pure insurance coverage, it is conceivable that a policy would go into the grace period immediately. For this reason, many companies are requiring a minimum initial premium such as the equivalent of three to twelve months of pure death benefit premium. This serves to stabilize the contract and provide for cash value accumulations to pay future premiums if so selected.

Another premium processing problem is that of handling periodic payments. Since Universal Life allows for payment or non-payment of premiums, the need to handle this degree of flexibility is of particular concern. Again, if an initial minimum premium is established that allows for a constant contribution to the pure insurance portion of the contract, this problem is diminished somewhat. But again, the attractiveness of the product as a whole is the ability to alter the premium payments, and although initial minimums may create a temporary safe harbor, companies must anticipate that in the long term they will be faced with changes in the premium contribution in the future.

Changes in Coverage: The flexibility of Universal Life to allow for changes in coverage is one of the design aspects that makes the product particularly attractive to the consumer. By the same token, it is one of the elements of the design that makes it extremely difficult to administer. Since the pure insurance side of the contract will change the amount of premium necessary either from premium collections or withdrawals from cash value, this flexibility has to be addressed by the administrative systems of the company. If additional premiums are contributed, the problem is greatly diminished. On the other hand, if the premiums are to be paid from withdrawals from the side fund, keeping track of these shifts of money presents a unique problem.

The handling of changes in coverages like that of many of the other administrative problems of Universal Life is a unique challenge. Changes in coverage present another problem to the insuance company; that is, the ability to project cash flow. Since an increase or decrease in coverage does not necessarily equate to increases and decreases in premiums (as long as cash values are sufficient to handle the premium changes), companies are finding it increasingly difficult to anticipate their cash availability. On a large scale of policies in force, this problem is diminished somewhat but initially companies must be sensitive to the possibility of increased liabilities without an accompanying commensurate increase in cash flow and assets.

Annual Statement Processing: The required annual statement to policyholders of Universal Life is one of the administrative areas that has never been fully resolved to everyone's satisfaction. Generally speaking, the annual statement will be different than the policyholder anticipated from sales proposals. The flexibility of Universal Life that initially appealed to the policyholder which allowed him to change premium payments, coverages, etc., will make this annual report of the condition of his "account" an unanticipated shock.

It is imperative that these annual statements be consistent with the prevailing state statutes, but a general rule of thumb to follow is that they should be as simple as possible. It should be taken as fair warning that the policyholder service departments of companies writing Universal Life will require a higher caliber of person than in the past to handle the anticipated influx of questions that are generated from these annual statements.

Control: Universal Life administration is the most difficult challenge to face the life insurance industry in many years. It is not unlike trying to paint a moving train. Administration requires the ultimate in timeliness and accuracy since all of the changes that may occur throughout the year must be anticipated. It is safe to say that not all potential changes will

need to be applied to all contracts, but the wise company should be administratively equipped to handle all changes for all policies and, thereby, have fewer surprises in their operations.

The control aspect of Universal Life administration really comes down to the nightmare of error correction. Since each subsequent calculation for cash value, calculated interest, expenses and cost of insurance coverage deductions are based on the preceding periods' values, the ability to correct errors demands the ability to recreate a policy's entire file. If your administrative systems are not geared to this "historical record keeping", chances are that difficulties will certainly arise. Most traditional life insurance product systems use a master file concept that keeps a minimum of history with updating of key fields of information. Universal Life systems on the other hand need to be able to recreate virtually every transaction that has transpired throughout the history of the policy, at least as far back as the last annual statement preparation.

This brings us to the question of how much history is necessary to be retained for Universal Life. When policy loans, partial surrenders and changes in the premium stream occur, as is frequently possible with Universal Life, the retention of history is of extreme importance. Because of the material errors that could occur, it is conceivable that one might conclude that "inception to date" history might be necessary. At a minimum, of course, the one year history for preparation of the annual statement is mandatory.

When addressing the administrative problems of Universal Life insurance, one thing is certain. Just as the design of the policy is a key to the ultimate success of the product from an investment and marketing standpoint, the design of the administrative procedures and systems is equally vital. Many companies have embarked on Universal Life marketing efforts without having paid adequate attention to these administrative requirements only to find that all of the initial appeal of the product was totally negated by the nightmares it created in the home office. Some companies are in the process of installing their second and third administrative systems for Universal Life because their first attempts were total failures. There is no sure way to protect yourself from this happening in your company, but be advised that the administrative personnel of the company need to be involved in the product's evolution from the very beginning. A product may be designed in a few weeks and marketing channels assembled relatively quickly, but the administrative requirements of Universal Life often take in excess of one year to design and implement. Those that have forgotten this important fact have suffered and are paying the price.

Universal Life - Automation

The administrative areas just discussed fairly represent the major challenges facing life companies that are considering Universal Life products. The particular design of a Universal Life contract may minimize the impact of some of these areas. The design may also require other administrative changes. If would be impossible to present all of the administrative considerations for Universal Life in a general presentation such as this. The specifics for a given company can only be done after a thorough review of the policy design and then only with an understanding of the subject company's current administrative capabilities and its available human resources.

Regardless of the company or the policy design, one thing is certain -- automation is a necessity. Even though some companies have introduced Universal Life policies without total revamping of computer systems, no one is considering the product for the long haul without being sensitive to the need for automation.

Once the concepts of the policy have been determined, the administrative areas need to be addressed. Will if fit with existing computer systems or will new systems be necessary? The answer is almost always that a new system of some sort is needed. The next question then is can this be developed internally, either by modifying an existing system or will it be necessary to develop an entirely new system from scratch? An alternative that always exists is to acquire a commercially available processing system from one of the many insurance software houses that offer Universal Life administration systems.

The evaluation of software, therefore, begins with the MAKE or BUY decision. The first step is to decide whether a software package is a feasible alternative. During this phase there are some considerations that need to be reviewed. They are: the functional application, the needs of the organization, the time constraints involved, cost, and in-house resources.

The Functional Application: You must determine if a particular application lends itself to a generalized solution or if your needs are unique. Some software systems have general application and may be capable of being modified to meet your specific needs. Others, on the other hand, are unique. Universal Life systems fall into this category and are designed for specific needs. Be wary of worked-over life processing systems that have been modified and are being marketed as Universal Life solutions.

Organizational Needs: An error often made when evaluating software is that prospects are more enamored with features that a particular vendor is marketing than the actual functions of the system. A functional evaluation is much more important. You can always analyze features at a later date. It is more important that the system evaluated handles the investment tracking, asset/liability matching, policy changes, commissions, etc., of your Universal Life design than it is to find a system that does things exactly the way you currently handle them. You must keep in mind that with Univeral Life administration things will change, so don't try to find something that does things exactly as you do them today. You will not succeed.

Time Frame: How long do you have before the system needs to be up and running? When designing a system or researching to acquire a system, consider the elements of testing, de-bugging, modifying and documenting the system as well as training in-house staff in the actual implementation. Be conservative in your estimates. Allow for staff turnover and adequate time to discuss all of the aspects of the organization as they relate to the system under review. Also consider the ability of the system to grow and be modified as you go into future generations of Universal Life and other non-traditional products.

Cost Factor: Costs to be considered include direct costs, such as the price of the system if acquired versus the cost of the system if developed in-house. Consideration needs to be given for lost opportunity costs during this evaluation.

In-House Resources: Needless to say, it would be impossible to implement any software system without adequate people, computer time and a thorough knowledge of the application being applied. Do not only consider the time availability of the data processing staff but be sensitive to the users as well. Often the computer time required to adequately design and develop an in-house system outstrips the capacity of internal availability. This would be a vote in favor of a BUY decision.

The make or buy decision is not easy at any time. When it comes to Universal Life administration systems however, it has generally held that most companies find it is easier to buy a system than to develop one in-house or to attempt to modify current Master File systems.

How to Evaluate the Universal Life Systems that are Commercially Available

Since a company is faced with a very real need to install application software to support its Universal Life activities, generally in a time frame inconsistent with its normal development efforts, too many companies make the mistake of coming to a hasty conclusion. There is a finite number of systems commercially available, and it is not too difficult to evaluate most of them to find the best fit.

During this evaluation most companies can determine if the system meets their functional needs and even do an evaluation as to the features they like of the subject systems. The requirements you place on your system should be categorized as to essential, desirable and optional. Be open to recommendations from the vendor. Even though he is clearly there to sell his system, he will have had more experience in Universal Life data processing applications than anyone else in your company. With a keen ear to what each vendor has to say, you will become very comfortable with the standard functions and features of these systems as opposed to the "marketing hype and fluff" that is standard from software salesmen.

Be sensitive to the quality of support that a vendor has to offer. Support, of course, is a very broad term. The ability of a vendor to support your needs and deliver a quality product within a reasonable cost and time frame is the major reason you will have elected to work with an outside supplier. If developing a system were your only objective, you may as well do it internally.

Review the documentation of the system. Is it clear and concise? Is it reasonable to believe that your administrative staff can easily use the documentation without major rewrite efforts? It would be far too time consuming to read every bit of documentation that a vendor might supply, but its presentation and macro-level content should be reviewed in depth. Some Universal Life software appear to be only rewrites of other versions of the vendor's other systems. The documentation usually gives this away regardless of the vendor's claims to original design.

Does the vendor supply training? If training is provided, you should determine from the vendor if they will address the standard components of the system as well as those necessary to tailor it to your unique circumstances. This training should be provided for the user areas as well as the data processing staff. Are there training materials available so that on-going training sessions can be conducted by in-house staff, or will you always be relying upon the vendor for future training needs? If there is no formalized approach to system training provided by the vendor, avoid him entirely!

Finally, evaluate the vendor himself. Is he financially stable, thereby indicating his continuation in the business so that future reliance upon him can be anticipated? There are many software companies emerging every day in the insurance industry that do not have the financial backing to provide this continuation of support. A good vendor evaluation includes an analysis of current users. Are they satisfied? Was their implementation successful? Was it within the time frames and cost elements quoted in the proposal? What kind of on-going relationship do they have with the vendor? Answers to these and other obvious questions will go a long way in raising the comfort level with which you can approach a long-term relationship with a software vendor.

The make or buy decision is one unique to each company. As mentioned, many companies elect to acquire software from an outside vendor. If this be the case, be cautious of overdoing your search activities. A prospective vendor, although he may know about Universal Life, knows very little about your company and its capabilities. Rely upon your experiences and the ability of your staff to implement the system and make it serve the company. The vendor, if handled properly, should be nothing more than an additional resource to your in-house capabilities. With the pressures of getting to market with Universal Life products, companies cannot afford to overlook the automation aspects of administration.

Conclusion

We have discussed some of the pitfalls of administering Universal Life. It is clear that to properly administer Universal Life requires sophisticated application software. If these two areas are approached in tandem the administrative nightmare that many companies have experienced with Universal Life may be a pleasant dream for you. Involve everyone from the beginning with the design of the product and the administrative solutions, and your chances for success are greatly increased. Those that have had tremendous administrative problems more than likely did not follow these simple guidelines. By this time, many companies have already solved these problems and the insurance industry, being what it is, is willing to share the solutions with others. Take advantage of this industry camaraderie if you are embarking upon the Universal Life path. If you are already down the path, we can only hope that you successfully identified and solved the issues discussed here. It is a different administrative problem than we are used to in traditional life insurance, but perhaps that is why they call Universal Life a non-traditional product.