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UNIVERSAL LIFE — THREE DIFFERENT VIEWPOINTS: STOCK, MUTUAL, CANADIAN

Moderator: ALLEN D. BOOTH. Panelists: ARNOLD A. DICKE, KEN MAGEE, JOHN PALMER

Welcome to the Panel Discussion on Universal Life at the 1982 annual meeting of the Society of Actuaries. Our topic is Universal Life three different viewpoints - stock, mutual, Canadian.

I am Al Booth, a consultant with the life insurance consulting division of Towers, Perrin, Forster & Crosby - Milwaukee office, where I have been for about a year and a half.

We will discuss three primary topics with a follow-up discussion of federal income tax questions.

Our format will be for me to introduce a topic, to solicit remarks from the three panelists, to summarize those remarks, briefly finding contrasts where possible, and then to move to the next topic. So, there will be some break in the appearance of the panelists at the microphone. Our topics are:

° Marketing strategy,

° Product line management

° Replacement programs

° Federal Income Taxes.

Let us begin by formally introducing our panel so that you might gain perspective regarding their comments. Each panelist will, when introduced, discuss his company's Universal Life history, his company's type -- stock, mutual, or Canadian, and its distribution method; which is important to the marketing strategy. First, on my far left is John Palmer, Sr. Vice President, Life of Virginia. John has a Bachelor's Degree from the University of Virginia. He is a 1970 Fellow of the Society of Actuaries, a Member of the Academy, and an Enrolled Actuary. He started with Life of Virginia in 1961 and has been in continuous service there except for a four year stint with Uncle Sam. His duties have included group insurance, group pensions, and corporate actuarial. He is currently product line manager for both group and individual life.

MR. PALMER: Thank you. My company is a stock company, of course. We started working on Universal Life late in 1979 and offered our first product for sale in the fall of 1980. This initial development work was carried out by a task force under the direct supervision of the president. My own involvement with Universal Life and with individual product work began in mid-1980 when I became responsible for product lines management for the company. Our main distribution channel was initially and still is our career agency force of about 1100, but we are achieving a rapid rate of growth through brokerage operations - mainly the larger brokerage shops. In initial stages the major internal challenge, as those of you who have tried Universal Life may already know, is administration which because of the product's extreme flexibility heavily involved EDP systems. This was left primarily to those specialists, but with heavy actuarial input. Perhaps our largest task and the one with which I was concerned involved gaining acceptance of the Universal Life concept in the external environment. This includes advertising, public relations techniques, state regulations covering disclosure, nonforfeiture, valuation, securities and exchange commission concerns, and last (and probably most) the main federal regulator of insurance the Internal Revenue Service. Our task in the early years was thus viewed primarily as making the world safe for Universal Life, a task which is still not complete.

MR. BOOTH: Thank you, John. On my near left is Ken Magee, Assistant Actuary with Crown Life. Ken graduated from the University of Waterloo in 1975, is a 1977 Fellow of the Society of Actuaries and is also an Enrolled Actuary. He started with Crown in 1975 initially working in the individual pension trust area from 1975 through 1980. Since the beginning of 1981 he has been involved in product design and pricing.

MR. MAGEE: Thank you, Al. My company, the Crown Life, is a large Canadian stock life insurance company. We market insurance in the U.S. exclusively through brokerage and in Canada through a career agency force and through brokers as well as in other territories. The Crown Life started promoting Universal Life insurance in the United States in December of 1981. We issued our first policy in March of 1982 and now have well over 150 million inforce. Our Canadian product will closely resemble the United States product and will be sold through a career agency force and through brokers. My involvement in the Universal Life insurance project was: given a set level of remuneration and constraints as to profitability design a Universal Life product. I then acted as the primary resource person to the data processing team and the administration personnel responsible for implementing the product. We should be in a position to process the monthly deduction aspect sometime in the next couple of weeks. You would think that most of the Universal Life business sold up until this time by the Crown would be impacted by a long lag in establishing administrative capabilities. It wasn't, because until July we did not sell business unless there was enough premium to guarantee at least one year persistency.

MR. BOOTH: On my right is Arnold Dicke, Second Vice President and Individual Actuary with the Penn Mutual Life Insurance Company. He is also vice president and actuary of two Penn Mutual subsidiaries, has been with Penn Mutual for nine years, and until two years ago was involved in the pension area. I find it interesting, also obviously coincidental, that all three panelists have backgrounds in the pension area. There must be some connecting link there between pensions and Universal Life. Arnold is a 1975 Fellow of the Society of Actuaries, has strong interest in federal income taxes and subsidiary management.

MR. DICKE: My company is Penn Mutual which is an old, relatively large, eastern mutual. We started working on Universal Life early in 1981. We introduced it to a test market in February of this year and nationally in April of this year. Penn Mutual depends almost exclusively on a career agency distribution system. Originally, the field force was not enthusiastic about Universal Life and it was the initiative of management more than the field to develop this product. Now we are finding that our field has been won over, plus it has been possible to get more involved with brokerage and other distribution alternatives. My role in the development of Universal Life was not in the product development area, but I was involved in the strategic planning and tax planning, subsidiary development, reinsurance arrangements, investment philosophy and financial monitoring aspects of the product.

MR. BOOTH: Actually the words "marketing strategy" constitute a slight misnomer, since the focal point of this topic involves the key decisions required during the Universal Life Insurance design phase. Each company has its own perception of its target market. The decision to bring a Universal Life product to a given marketplace must occur in an environment indigenous to that particular company. Some have made this entry offensively, some defensively. However you have entered, you should know where you are headed with the product and why. Design parameters in Universal Life must be influenced by the kind of distribution system employed in the company's usual operating style and so on. In particular, if your company is working with brokers and if those brokers have certain expectations, that says something about how you might construct your product. If you are in a different operating mode, you have different things to consider regarding product design. How should your product design differ by company type regarding: load structure, asset and interest crediting mechanisms, the mortality basis chosen,and so on? How should these be related to the critical differences from company to company? How can we avoid merely copying XYZ company's product? These are the issues that we would like for our panelists to address. Mr. Dicke will start.

MR. DICKE: Thank you, Allen. I was wondering why the Society of Actuaries chose to hold this meeting in Washington in what to me is a new location at the Washington Hilton. Then I saw that across the street there is a building that is aptly named the Universal Building. Furthermore, in the Universal Building there is a restaurant called the Universal Cafeteria. Now that seems an appropriate symbol for the unbundled type of product we are talking about. But to push the analogy to its limits, the Universal Cafeteria actually has in it a newly installed Pac-Man game - that finishes out the image very nicely.

In any case the only relevance of these observations to marketing strategy is that just as in building a building, you have to start with plans. This is particularly true in the development of a product that differs as much from traditional offerings as Universal Life. At Penn Mutual, we did a great deal of strategic planning and this experience leads me to believe a strategic planning process is absolutely critical to mutuals who want to take an action which is such a big departure from the traditional.

I have been asked to treat this subject from the point of view of a general mutual company, rather than that of my company alone. So suppose you were involved in a planning process aimed at introducing Universal Life into a medium - to relatively large - size mutual company. Your company probably has substantial surplus, but it would also have a large block of old traditional policies, a career agency force that is becoming more and more expensive to maintain while producing less business than you would like to see.

Now suppose that your management had decided on some target markets and had decided to attack these target markets through the agency system. But instead of the usual middle class family planning markets, management had decided to go into the high income market, estate planning, the professional market, the small business market.

I think this probably describes where a lot of the old mutuals have decided to go. Also, management might have decided that one of their objectives was to broaden their distribution systems and move into areas that are served by brokers, possibly looking again for sales to the small business and professional market, but also to larger businesses by salary allotment programs and the like.

To set the stage further, suppose the environment was what it was in early 1981. We had a tax situation prior to TEFRA that was bad for traditional products (let's assume you were Phase I for tax purposes). We also had very high interest rates, and perhaps even more significantly, an invested investment yield curve with short term rates higher than long term rates. At that same time, the usual breadwinner of mutuals-the whole life policy-was subject to many attacks in the media by consumerists and government agencies who made damaging statements about its rate of return.

Also, early 1981 witnessed the entry of stock brokerage firms and other non-traditional competitors into the insurance marketplace, provoking speculation as to whether this was a sign of the future.

Conversely, your own agents, as well as certain insurance companies, were beginning to think about themselves as being in the financial services business rather than insurance "retailing".

Thus, you find yourself in an environment that has changed immensely from your traditional environment and contains many volatile elements. Given this situation, it is time for strategic planning.

You would find that a number of strategies will emerge. The principal one that people were considering in 1981 are what I call the "boutique" strategy and the "price competitive" strategy. The "boutique" strategy involves staying with your traditional markets, producing specialty products better than other people can or will. Many varieties of new products or slight variations of current products to fill various market niches will be requested on a bottom-up basis by your agency force.

The other popular strategy addresses the price competitive market, which, of course, is where the brokers, and more and more, where your own agents are. In fact, agents are being faced daily with price competition in their traditional markets. At Penn Mutual, while our agency force wasn't initially enthusiastic about Universal Life, in those parts of the country where Universal Life had been introduced by competitors and where it was being seriously pushed, general agents would become very concerned that they couldn't compete without the product. It looked to us as if this, too, could be a sign of the future.

Once you have adopted a basic strategy, it is time to look at what the role of Universal Life might be. In a price competitive strategy it can be very important. It packages the product better to compete on a "price" basis. "Investment through-put" becomes the critical factor since it is the easiest "price" to look at. You are showing a rate of return of some sort, and it is important that the rate look at least reasonable at first glance so that prospects look a second time. Tax efficiency becomes critical. Interest rate sensitivity is also a major factor. This can be something of a problem, because no matter how you try to design the interest rate element, it is going to go up and down. When it goes down you may lose a lot of the business that you had put on the books. So, you might want to hedge your strategy, perhaps by keeping your traditional policies in place and up-to-date, or possibly by thinking in terms of some sort of variable life product or later version of the Universal Life product with longer term investments available.

So far, I have assumed that the strategic planning took place prior to TEFRA. In the post-TEFRA era, it may well be that the flexibility of the Universal Life is going to be more of an advantage than any other feature. In an environment that features a normal yield curve (with long term interest rates higher than short term rates), it may be that Universal Life will also prove useful in the boutique strategy.

Given the decision that Universal Life fits in your basic strategy, the next step is to review its critical factors. For example, if you have decided on the price competitive strategy, the critical factors would seem to be these:

1. Tax efficiency. In the pre-TEFRA environment it appeared that achieving tax efficiency would require very extensive tax planning, perhaps including the use of stock subsidiaries. Reinsurance might have been part of the solution. In addition, indexing might have seemed to be a good idea, since an indexed product might prove less vulnerable than other approaches to IRS's contention that the excess interest is a dividend. But if you decide to index, you face questions: What index, how long will you commit to the index and what loss would you sustain if the rulings go the wrong way?

2. Systems. A second critical factor is systems. System development is the critical path for Universal Life product introduction. The companies that have succeeded in getting the product out quickly are those that have done an excellent job in the systems area. Inadequate systems can limit the flexibility of the product, and this is one of its key marketing advantages. Proposal capacity in particular is difficult to achieve initially.

3. Field Acceptance. A third critical factor is field acceptance. In 1981 Universal Life products mostly produced relatively low compensation as a percentage of premiums. Of course the sales were larger and that made up a lot of the difference. But over time, newer products were developed with higher levels of compensation, eliminating this barrier.

   Another problem in gaining field acceptance was the fact that the old marketing methods didn't work in the same tried and true way. Actually, complicated presentations that agents had been making using minimum deposit techniques, paid-up additions and other features in all sorts of interesting combinations could be handled directly by Universal Life. The new product made these presentations simple and straight-forward, and some field people found this hard to believe. It really was a matter of getting them to what you might call an "ah ha" point with the realization that what had been done previously in a very complicated manner could actually be done more simply.

A third problem in winning over the field was that agents were not sure how or when to sell the new product. They didn't know what its proper use was. They needed direction. Additionally, in 1981 they needed reassurance on the tax situation for the policyholder. Indexing was extremely helpful here. One of the most effective programs for overcoming such lingering reluctance is test marketing. If a few areas of the country can be used as an example, the rest of the field will turn on to the product.

4. Replacements. One other critical factor, of course, is the replacement situation. Replacements are a particular problem for newer, recently issued policies. However, the other side of the replacement issue is that you are going to be losing a lot of in force business to competitiors. Even your own agents are not so loyal that they won't take a policy or two down the street. A new Universal Life product might help you recapture some of the business that was being lost. These factors have to be considered and balanced during strategic planning.

MR. MAGEE: I will open with a couple of words about the Canadian environment for those of you who aren't familiar with it. As we saw it, Universal Life developed in order to satisfy at least three separate marketing needs. The first is flexibility. The second is need for a product that is sensitive to the current interest rate environment, whatever that might be, and that is able to respond to changes in that environment after issue. The third need was for level premium, low premium policies with low cash values - the premium being low commensurate with the low level of accumulation. I am not too sure about the U.S. market, but particularly in Canada there is a demand for insurance in which the savings element was not paid for, but yet the level premium style was maintained.

With respect to flexibility and the ability of various different products to satisfy this need, Canada and the U.S. are not that much different and flexibility is in fact, as I see it, the primary reason for the UL entry into Canada. With respect to products sensitive to current new money interest rates, they were already available in Canada before UL became a hot topic. These were level premium whole life contracts in which the amount of death benefits and/or cash value and/or premium would be set at issue in accordance with the expected investment results of anticipated cash flow for that policy, with adjustments to be made periodically to reflect changed prospective expectations. On occasion investment strategy and the product design could be very very closely linked. For example, you might see a planned quinquenial pattern of reviews for a product that is backed by five year residential mortgages. With such products available the need for the new money or current interest aspect of UL was much less acute in Canada than it was in the U.S. Also, Canada does not have legally mandated minimum cash values. Thus, the level premium whole life policy with very low cash values, with only non-cash-type nonforfeiture values at all (with correspondingly lower premiums) were already available. In the U.S. the only way to provide a current interest, current mortality, product in return for a low level lifetime premium, without violating the standard nonforfeiture law, appeared to be UL.

As such the prime reason for the development of UL in Canada is flexibility, which is also something that most Canadian companies have quite a bit of experience with through several years of issuing flexible premium or casual premium annuities sold in conjunction with what we call Registered Retirement Savings Plans - Canada's older version of your IRA. As I mentioned earlier the product that we have introduced is a U.S. product despite my Canadian input here. Again I will repeat that the Canadian product would have been very very similar, and in fact will be similar. My company's traditional long standing goal has been to go after the upscale market. By being pure brokerage in the U.S., this happens pretty automatically. In Canada we gear our recruiting, our training and our sales support to the bigger ticket sale. Since the high end of the market target is enshrined in our planning process as a very clearly stated goal, we did not discuss this much in developing UL except to decide to take an aside to that goal and develop a salary deduction product as soon as we could after introducing the primary or "street" product. As a Canadian company that entered the U.S. market by way of a pure brokerage and managing general agent operation, our style has been to pay what we feel are very strong agent commissions - we believe very strongly in the agency system - and to offer competitive products. In developing UL we were concerned that the brokerage community would not be attracted to a low commission product as was then primarily available. Further, in introducing UL later to our Canadian field force, we wanted to ensure that they could continue to make a living in the event that UL might become either their primary product or a primary portion of their portfolio.

Therefore, we chose a remuneration scale and then backed into the loads necessary to provide them rather than working the other way around. And we ended up with a relatively competitive, although relatively heavily loaded, product with whole life type commissions. We felt that the neon sign at the time that we introduced the product late in 1981 was the interest rate and felt there was a need for an interest responsive product. Despite the fact that the product's street durability would be provided mainly by flexibility, the best way to provide an instant response to market investment conditions was new money. So, we went that route with each premium payment being tagged with that day's interest rate, using a higher remuneration product that is not designed for lump sum roll-in business. We did not expect and do not expect very much in the way of investable cash before early or mid-1983. We have not paid close attention to the asset management issue. We discussed indexing and decided not to index for two closely related reasons (1) investment flexibility and (2) allocation of surplus between different lines of business. We wanted very much to be able to move easily and quickly from one type/style/duration of investment to another and that goal in conjunction with indexing would involve setting up mismatched reserves. As a rapidly growing stock company we guard our surplus very jealously and the advantages of indexing did not seem pressing enough to warrant the risk of tying up surplus to back it.

With regard to the risk or mortality charges, two considerations dominated our thinking. One major problem in designing a transparent or see-through insurance product is: where do you hide your expenses? An aggregate-style schedule of risk charges allows you to use the difference in the early years between the aggregate charged mortality and the select experienced mortality to defray expenses without being offensively obvious about it. Secondly, the whole point behind Universal Life was to develop a product that could survive a lifetime of changing needs and environments. Introducing into that lovely ideal the problems that accompany select-and-ultimate term rates did not seem appropriate. We considered smoker/non-smoker rates and in fact will move to smoker/non-smoker rates. We chose not to introduce the product on that basis originally, waiting until we had our administrative capabilities in place.

MR. PALMER: We are charged with giving you some notion of the thought processes involved in coming to grip with the key decision elements related to marketing strategy. Let me start with a few general remarks. This is not a closed process. We and I am sure the other early UL entrants are still grappling with these questions. UL is not a single product but rather a whole family of possible products. What was good last year is not necessarily good this year. What is good for the career field force is not necessarily good for brokerage. And within a given distribution system there exist various specialized needs requiring UL forms with particular characteristics. One thing which was not of great concern to us was the competitive placement of our Universal Life products in relation to others' products, simply because there were so few. But this will be of concern to anyone starting today and indeed is of concern to us as we develop new variations. The basic starting point in our case was the available distribution system, from which followed the target markets which they served. This, I think, must be the starting point for any company entering the UL market. One can hope to develop alternative systems as we are doing, for example, with brokerage, but certainly the current resources must weigh heavily. I will go through some of the thoughts and questions we addressed and, because our situation was not an uncommon one for many medium-sized old stock companies, some of you may find some useful guidance from our experience.

Our career field force has developed to its current state from being a more or less typical combination agency force 20 or more years ago. We had conducted an aggressive but evolutionary effort to make it a nearly pure ordinary force with a concomitant upgrading in the markets they serve. This effort was largely successful but resulted in a decline in the size of the force from 1500 or 1600 down to the current 1100, largely as a result of trimming unproductive and unadaptable agents. The first questions we asked ourselves with regard to the distribution system was how many of our field would be sophisticated enough to handle UL. In those days there wasn't a widely prevalent state of knowledge about how the product works. This is perhaps not as big a problem today but it was a very real problem in those days. Next, the self-replacement problem: how could we control that? There is going to be more on this in a later section of the program so I won't deal much more with it, but it was a great concern at that time.

What compensation level will be needed to get the agents' attention and how much can be made of the increase in frequency of sale and increase in size of sale to gain acceptance by the field force of the almost inherently lower commission level per thousand or per premium? Is the product really appropriate for the markets that our field force is used to serving? The results of our answers to these questions were as follows. Our initial UL offering had a minimum face amount of \$250,000 which was later reduced, perhaps six months or so later, to \$100,000. This was done, of course, to limit usage to the upmarket sophisticated agent and to provide some pull through pressure to bring other agents upmarket. In addition to that we adopted some rather severe commission chargeback rules for the internal replacements. These by the way are much more difficult to hold to currently because of the great increase in UL competition.

Getting into the product itself, let me cover some general points on pricing and product structure. We thought it important to insure self-sufficiency of the various elements of the products, that is, the insurance coverages piece, the investment piece, and the expenses. Because of the flexible nature of the product we thought each piece had to stand pretty much on its own two feet. Relative simplicity counted for quite a lot. Now it's hard for our agents to believe that we had anything relatively simple in it but that was our major concern in those days. We thought it was necessary to help the field force understand it, the customer understand it, and may be a bit easier to administer also. A very major problem at that time was taxation. That was very unclear then and to some extent still unclear especially in the company tax area. We used the best legal advice that was available to us at the time as a basis to construct the indeterminate contract elements. Our general conclusion on company tax was that there exist some advance guarantee period less than the full duration of the contract but probably greater than one year which would cause post-issue adjustments not to be treated the same as retrospectively determined credits, i.e., dividends. We chose three years and used a rolling guarantee structure whereby guarantees exist three years beyond any particular given date. In other words, the right to change a guarantee can only be effective three years from that date of decision.

In the policyholder tax areas we really never had serious doubts that UL under some sort of conditions would receive normal Section 101 (a) treatment. The only question was - what conditions? We used a percentage corridor test as well as a dollar test to avoid the million dollar face and ten thousand at risk type of abuse example, and we also had a fairly stiff internally administered requirement on the relationship between premium and face amount in order to minimize policyholder exposure at some later date when final guidelines were set.

Getting into the specific elements in the area of mortality and cost of insurance rates, decisions one faces are: a choice between fixed or indeterminate rates (I suppose it is possible to have fixed rates but I don't know anyone who has them), select and ultimate rate, smoker or non-smoker rates (there are big systems consideration here obviously, but they are problems either way). The competition seems to be going toward and probably will continue toward greater so-called refinement, especially as the systems make this possible. Select and ultimate raises re-entry types of questions, and smoker/non-smoker creates problems where the CSO table is a mortality maximum. There seems to be some doubt as to how that should be handled. One way that I understand this is being done is to treat smokers as non-standard and justify using a maximum higher than 58 CSO. Some states take issue with that position. With regard to applications of ratings, whether multiples of the standard rate or rating off the smoker and non-smoker separately, handling various layers of rated coverage can be quite an administrative burden.

Another category of questions is whether one could band the rates by the amount of insurance. How can this be done with a flexible policy like UL? I don't know any policy that does this yet but I suspect something of the sort might be coming.

In the area of the general level of interest credit, you have the same sort of considerations you do with any kind of a current interest product, such as SPDA's and so forth. Our view is that the credit should be a function of the underlying asset management strategy that you have in mind. This hasn't been a great problem in the last couple of years of inverted yield curve, but if the current normal situation stays normal some strains will develop because of difficulties in reconciling long term yields with a capital loss exposure from cash value demand. Perhaps investment markets will create instruments around which we can conceptually wrap UL liabilities still within the general account, such as long term variable rate instruments.

One is also faced with a choice of indexing or not indexing. Advantages we saw for indexing were, first of all, a marketing advantage since the policyholder doesn't have to take on faith that you will be fair to him in the future or at least for as long as the index prevails. In addition, perhaps, a longer duration guarantee with less risk is possible under an indexed approach. On the other side, the valuation questions raised with indexing haven't yet been solved. I think the state of California has some guidelines that suggest some special treatment of indexed products. I think they are still proposed guidelines. In addition, indexing may encourage unduly long guarantee periods, which can be dangerous in view of the tax and valuation uncertainties that presently exist.

In the area of loading structure there is great amount of latitude. This is really a function of the compensation level desired or needed, and presently a very wide variety is now found in the marketplace. The trend seems to be toward higher commission, higher compensation in the newer products, but I don't think the lower compensation products are totally disappearing. It is my experience that the career field force is a bit less compensation-sensitive than the brokers are. The career field force's initial reluctance has largely been overcome by their large increase in the average size of sale. Another consideration for loading is the degree of matching of revenues and expenses that is desirable or necessary. There seems to be a trend away from the really strict matching that was found in some of the earliest products.

A great variety is now found as to form: front end load, rear end load, almost no load (or no visible load), various combinations of flat amounts, percentages of premium, and so forth. I would expect to see individual companies developing fairly extensive portfolios of UL products to appeal to various target markets and particularly to various distribution systems. There is one problem in this area of developing various high load/high compensation vs. low load/low compensation products: that is possible problems with state unfair discrimination laws. This is something that hasn't really been tested much but I suspect the opportunity may arise.

A final point to consider in the loading area is the likely and current future state of non-forfeiture law requirements. Current forms have been accepted under the '76 law (I think all have been under that), generally by means of an algebraic transformation of the present prospective form of the law (as it applies to traditional policies) to a retrospective expression, and then a comparison element by element of this expression with the elements of the policy's cash value algorithm. The 1980 amendments call for a promulgation by insurance commissioners of regulations for non-standard forms. Such regulations are supposed to be based on principles consistent with the law for standard forms. The ACLI has been working on this for the last couple of years in developing a model regulation for this purpose and I think that is probably going to be discussed at one of the sessions tomorrow on the 1980 amendments. I would suggest anyone who is interested in UL to pay some attention to that session. The final form of these regulations can have a material constraint on the loading structures that are possible.

MR. BOOTH: I think most of us have probably been involved in UL product development and recognize it to be a quantum leap in product design theory as opposed to the jiggling that we used to do in trying to innovate within our product portfolios. One common thread that I hear from all three speakers is the importance of considering your marketing plan, your strategic plan, and your asset management capabilities as you make your decisions with your UL products. You absolutely must consider the distribution environment and your distribution systems. We see a lot of focus on the up-scale market, although one of the panelists did mention the payroll deduction market which may well have great importance to our operations in the future. In substance many of us see UL as a way of changing somewhat our distribution system and there are companies utilizing this product, either knowingly or defacto, as a means of changing the way in which the product is distributed from the company. Hopefully, that change is conscious and UL is being used as an agent of change and that you are not making the mistake of letting UL lead your direction; rather, that you are using UL to pull you in the direction that you wish to go.

Planning is obviously of importance. OK. So you decided to design a UL product and you have done your planning, you have rushed to get the product developed, filed and approved and it is in the hands of your sales force. Your troubles are over. Wrong, they have just begun. You are about to face a new challenge. Namely, management of the UL product line. You are about to face problems of the following nature: How do you segment your assets, do you do it intentionally, do you do it on a worksheet, do you identify the assets and the investment yields that accrue to your UL block of business? You are about to be facing decisions regarding next month's credits and possibly next month's risk charges, if you do in fact review those from time to time. And you are about to face new requirements in terms of how you report results of your product line to your management. What does persistency mean now? Your agency people were probably excited about their average premium per 1000 or their average premium per case. How do you measure that given UL. Expenses. Actuaries have long been very competent at analyzing expenses. But are you now capable of matching your actual UL expenses against those expenses charged with your product, and in fact have you looked at the development costs that you have had in your product as you came up to speed. Do you know that you can produce enough business or do you know how much business you need to produce to amortize your development costs which may be substantial? Then, also there is the subject of reinsurance administration and many other things that we need to think about in terms of running this line of business.

I would like to turn to the members of the panel for their experience in this area and begin with Mr. Magee.

MR. MAGEE: Starting with the asset segmentation question I alluded to earlier, we are not likely over the short term to track the asset backing our UL product in great detail, separate from individual non-par life. Instead we will, in detail, record and use the timing of cash flow both in and out and our known UL insurance investment strategy to derive a picture of the assets underlying a given policy or a block of policies on pre basis. Since interest rates are set prospectively on a new money basis and the funding is not long the reason we would track assets is primarily to detect deterioration in market value rather than to bring this into the interest rate setting process. Our current interest rate was designed specifically to be very simple to set. Our rate is set with respect to funds to be received currently as a new money rate so we don't need to worry to a large degree about existing assets, and the rate is set by looking at the expected interest rate to be earned by current investments using our known strategy and subtracting a fixed interest drag, which is fixed, explicit and is established as part of the pricing and design process. Interest rate changes that would be trivially small are avoided by allowing a spill of perhaps a half percent or so on either side of the intended average drag so that if the current rate is within a half percent of what we would otherwise credit we would leave it alone. This rate is then applied to all funds received between the date that is set and the date that a new rate is set. The review period is currently around three weeks. We are flexible on that. We hope not to have to review it daily but on either side of three weeks we are quite comfortable.

Once the interest rate has been assigned to a premium, it is earned by that premium and the values that derive from it for a period of one year with a guarantee that it will not change. At that time a new current interest rate is assigned to the fund as it rolls over into a new one year guarantee period.

With regard to our risk charges, they were derived empirically as part of the pricing and design process. We intend to review them annually, or as is practical, by way of an inforce pricing technique whereby we would take a block of policies, walk them through an assumed issue date to an assumed current date based on the expenses, interest, mortality and profit that were built into the original price. This goes back to the par and non-par discussion and our posture is that we should not be passing along or recouping experience from the past. It is a prospective pricing process. We then project new experience factors from the experience that we derived for the block of business and test it for profit. If it has become more profitable than we originally intended, we can either increase the drag against the interest rate or decrease the risk charges, marketing and other considerations governing, or both. If the profit has reduced then we can increase the risk charges or increase the interest drag. It is our anticipation that the risk charges themselves will probably be quite stable. Measuring our experience is going to be an interesting experience on its own. Over the short term we have measured persistency at my company automatically since three year persistency drives our bonus sytem. The interesting point here is that we had to sit here and think about just what is an inforce policy. We can't use premium flow, it can vary widely from one year to the next, we can't use the exercise of non-forfeiture options because a policy that is acting as reduced paidup or extended term insurance looks no different from any other UL policy and we can't even turn to automatic premium loans as a criterion because the whole concept is meaningless. What we finally decided was to do the simple thing and treat any policy that is inforce as "inforce". If there is enough cash to pay a monthly charge, well then it is fully inforce and no different from any other UL policy in that respect. Average premium per thousand in the long run is not going to be an easy thing to do. Again, having spent a lot of time on that, you might be interested our average premium per thousand in the first year has hovered very stably around $12 per thousand both for the level premium, death benefit option and the increasing death benefit option, oddly enough. I am really not sure what the reason for that might be. As to expenses, my company allocates them by line and territory and between life and annuity, but not by product. As such, we will have a tough time, if indeed we try, putting a price tag on the development and the non-data processing administration of non-UL. Another consideration to mention there is that the experience that we gain from

UL administration systems has already proved useful and has already been used in other areas such as new money individual annuities. So it is likely that UL developed a lot of its own technology that will be used in other areas. In contrast to expenses, we can analyze mortality nine ways from Sunday. You can look at anything from mortality. It probably isn't going to tell us a whole lot. I don't believe we expect UL insurance products' mortality to be really that much different from traditional ordinary non-par permanent mortality partly because we designed this as not a traditional but as a whole life type product. One analysis that I don't believe we do, if we do no one told me, might be interesting, is an end point survey of death claims. UL gives us what I think is a unique opportunity to look back from claim situations to see what patterns developed prior to those claims, and what these policies actually look like while they were leading up to a claim for one reason or another.

With respect to reinsurance, our activity has been relatively conservative with respect to UL. We have involved the mortality risk only. To my knowledge we have neither ceded nor accepted investment risk. The administrative problems are substantial, though. Unlike a traditional policy, you can't project the risk pattern several years into the future without a significant risk of being wrong. What I believe we expect to do is to look back periodically and adjust the risk amounts charged or credited to bring them into line with what was actually experienced. All in all, the measurement of experience with respect to UL is certainly as important as it has been for any other product that we have offered.

MR. PALMER: I take the basic task of product line management to be that of insuring that the line in actual operation is delivering the result expected of it when it was developed, and of adjusting and accounting for the differences that arise. A basic prerequisite for successful product management is, of course, a sensibly designed product to begin with. In the case of Universal Life, management takes on new dimensions, since the array of post-issue alternatives is greatly expanded, although, of course, still limited by the declaration of future guarantees and competitive considerations.

With regard to asset segmentation, we feel that some form of national segmentation is nearly mandatory with any kind of current interest products. A company with a normal range of product offerings which include them will have a rather heterogenous set of asset structures demanded of it by its various liabilities. There have been a fairly large number of recent write-ups of segmentation approaches used by various companies. These are in the Record of the Society, the ACLI Investment Section, LOMA, and other sources, so this is probably not the place to go into details of that kind of thing. But I would advise anyone entering Universal Life to review the current literature in this area in advance. Full-blown segmentation systems seem to be a rather massive undertaking. We don't have one. We found that setting up the Universal Life administrative system was enough to swallow initially. But we do provide for what we feel is adequate monitoring by earmarking for current interest products certain assets. In effect, we segment into current interest categories (a different category for each type of interest crediting mechanism is probably needed) and all other. We provide the investment personnel with periodic cash flows and fund balances for the various categories and they adjust investment actions accordingly. The investment department should, of course, be aware of the interest rate determination mechanism. Here I use the word "mechanism" to cover both an indexed and a fixed-rate approach where there is some routine method established for setting the fixed rates. As a practical matter, the investment people no doubt would have participated heavily in the development of the mechanism in the first place. Then the investment mechanism undoubtedly contemplates some kind of investment strategy. It then becomes quite valuable to account for the variances by source that arise; for example, from time lags, from investment expense variations, from actual vs. expected spreads, from early calls of the investments if you have that kind of investment; these details, of course, would vary considerably depending upon the particular mechanism chosen. The point is that it's important to try to track the sources of deviation and adjust to the extent that you've allowed yourself to.

As to deciding on new interest rates, of course if you've got a mechanism or if you've got an index, then it becomes more or less automatic. However, even with a non-permanent index, you still have the question of whether you care to extend the use of that index or not, or make some adjustment. In our case, of course, we just follow the index. We do bolster the use of our index by having our regular auditors certify to the accuracy of the calculations, that is, they are provided with the appropriate Board resolutions and they do their own calculations giving us reports that confirm that the numbers we came up were indeed correct.

For non-indexed products, there is presumably a bit more latitude. There's less risk in case the original investment plan goes astray but there are several constraints on risk charge changes. There are state regulations that control indeterminate premium re-pricing which seem to have been made applicable in some cases to Universal Life factors, such as the interest, mortality, and any discretionary expense charges. No doubt you'll encounter those when you file in the states that take that view. In addition, you've probably already received a recently distributed exposure draft from the Society called the Report of the Committee on the Theory of Dividends and other Non-Guaranteed Elements in Life Insurance and Annuities. Draft recommendation 13B covers both par and non-par policies as to items with respect to which the company has post-issue discretion. It does explicitly cover Universal Life. You might look particularly at paragraph 12-1 which says that there should be no increase in the provision for profit and risk unless there is in fact a clear increase in risk.

In reporting of the actual experience, I am constrained to talk about what we would like to have and not what we're getting. The main task of our systems at the moment is to get the business issued, pay the commissions properly, keep the transactions straight, and other things of a study nature are more in the "nice to have" category. The rapid pace of product development keeps us from really making much headway in the "nice to have" category because the systems are continually being modified to deal with some new type of wrinkle in the product. A major difficulty, as Ken mentioned, is that traditional methods don't really work too well here because of the extreme flexibility of the product. In the production area, we try to get something like annualized premium and settle for what we call the planned periodic premium; we try to exclude single sums arising from rollovers to the extent possible, but since this planned premium need not be paid, it's a somewhat dubious number. It's not as bad as at first glance, however, because a great portion of our business is on automatic bank draft which inserts some element of stability. One could also use the face amount but this can vary from a near-term to a near-endowment type of plan. We feel fondest, I guess, of a commission-based measure, that is some transformation where $X of commissions equals a nominal $1,000 of insurance. That's probably what we're going to go to exclusively in the future, since we can provide almost "apples-to-apples" comparisons.

The proper measure to use, of course, depends on the purpose at hand. You've got many pitfalls when you try to compare Universal Life production numbers with traditional production numbers. This is where the commission-based measure is particularly useful, at least to the extent that the value to the company of a certain quantity of product parallels the compensation paid. In getting average premium-per-thousand you have to worry about what the real premium is and try to pull out the rollovers to avoid distortions.

As Ken mentioned in discussing the experience items, the unbundled nature of the policy really invites an analysis of gain and loss by source to a much greater extent than on a traditional product, and no doubt we will do this in the future, but at present, only the investment experience is really tracked closely. In any case, the exposure here is so small and new that probably nothing significant would be learned. Persistency is a particularly difficult problem; in fact we dropped the factor in our compensation scheme that depends on persistency, simply because we couldn't find what we felt was a meaningful number. One could distinguish, for example, between suspension of premium payments and actual lapse and treat the two differently. Of course we lack any kind of expectation as to what normal levels or satisfactory levels of either types of "lapses" would be. Probably your interest in persistency is a direct function of the degree to which your anticipated profit depends upon it. If you've got a high degree of mismatching or advancing involved, then you would be much more interested in it.

MR. DICKE: Product line management runs into a different set of problems if the product is subsidiary based. Obviously, subsidiaries are there to help with asset and tax management, and they do, but they cause complications. One of the first things you have to decide is how you're going to use the subsidiaries: Should you sell directly from the subsidiary, or should you use some sort of co-insurance arrangement to transfer the business from the parent? Especially since the passage of TEFRA direct selling is necessary if you want to have the product treated as a stock company product. But this means, of course, that you have licensed agents and general agents, and duplicate many features of the parent in the subsidiary.

In subsidiaries, a certain amount of investment control is achieved automatically because the assets are automatically segmented in a separate company. This means that investment earnings are automatically accounted for and you know what product they derive from. On the other hand, the subsidiary approach involves surplus requirements which can be very tricky. In order to immunize a product in a subsidiary, you must get cash or relatively short-term securities into the subsidiary. This can be a major stumbling block. You need to be able to get a lot of cash, since you'll have a surplus strain the first year which must be funded in cash if immunization is required. That can be a problem.

It's also very important to be able to forecast surplus requirements accurately. Statements are required not only once a year, but quarterly, since several states require quarterly statements from small new companies. If you're licensed in New York, you're also going to run into some restrictions on the rate of growth. Reinsurance arrangements will undoubtedly be necessary with a subsidiary: it's a new company and it can't retain much of the risk. Many of these arrangements can be with the parent, but an arms-length relationship is required. You may want service agreements, exchange provisions, etc. between the parent and the subsidiary. All these things result in extensive administration which your managers and your systems have to handle.

But let me get back to the asset management question. Many products have a provision whereby the first $1,000 does not receive excess interest. The great advantage of this approach is that the first money that is received on a new contract does not have to be immunized. Of course, it might become a marketing disadvantage as time goes on. But apart from this design feature, you must come to grips with the problem of immunization. Assume you have one-year guarantees that are declared monthly. One approach is to establish monthly funds, then estimate liability cash flows and asset cash flows and fill in the gaps when investing new cash. Of course, you can use unmatched strategies to increase the yield. In other words, you can allow the investments to have a different maturity structure from that of the liabilities, but the downside risk can be pretty substantial, as mutual company people, looking at their book of ordinary policies, should well understand. So it depends on the risk tolerance, which in turn depends on the amount of capital or surplus of the parent that's available to the subsidiary. It also depends on whether or not there's any use to be made of losses. For example, are there any tax advantages to running losses? With the ability to consolidate life companies on a bottom-line basis, and with the mutual parent facing a show-down of new business, the losses may prove vital.

Next is the question of setting the rate. You have three choices here. First, you could have a portfolio rate, but this has the same problems in a Universal Life product that it has in an ordinary life product: it can get out of date. You may start with a new portfolio rate that looks a lot like a new money rate, but that illusion will not hold up over a long period of time. Second, you could have an Investment Generation arrangement, but once again you have to worry about too much long-term investing which could create a market value problem if you have any sizable amount of surrenders. Finally, if you have an index you're going to have to keep your maturities fairly close to what your index asks for.

How often to change the rate is a very important question. Too infrequent changes will encourage investment anti-selection. If you stay with a rate that's out of place in a falling market, you can get a lot of money in, and that isn't good unless you have arranged to invest it at that rate.

The administrative problems inherent in using a subsidiary are significant. Expense allocation can be a big problem, especially because you are trying to maintain an arm's length relationship between the parent and the subsidiary.

Profitability also requires managing. For example, suppose the recent change in tax situation invalidated your initial estimates. You might think about increasing the minimum size, but that doesn't have as much effect as it would with other kinds of products. On the other hand, investment spread is an important element; a rule of thumb (which of course depends on the particular pricing situation) is that if the investment spread is increased by 1%, the rate of return on capital is increased by 3%. Another area in which you can gain is the lapse risk. If, somehow or other the risk of lapse can be partially shifted to the sales force or the client, profitability can be improved.

A very important consideration for a mutual company is equity. I discussed this last year at the Atlanta meeting. In my view, there are two basic theories as to how to relate the policyholders of the stock subsidiary to the parent company. In the first theory, the subsidiary is an investment that belongs to the mutual company parent and consequently to the owners of the mutual company who are the participating policyholders. The other theory holds that issuing non-par subsidiary-based products is actually only a device to achieve investment and tax advantages, and that in reality such products should be treated exactly the same as the participating products of the parent. The distinction is very important and it hasn't always been dealt with in enough detail when mutual companies have begun marketing Universal Life. The distinction may dictate the degree of consistency required in pricing assumptions such as mortality and expense (investment results are of course, distinct). It may also indicate what the proper rate of return on the company's investment must be.

The last thing I'd like to mention is that in managing the product line, you also have to look to the future. Innovations such as "Universal Life II", the variable, multi-fund Universal Life product, will require a whole new concept of product-line management. This is a subject which I expect we will be talking about at another meeting in the future.

MR. BOOTH: One common thread that I recognize in listening to these three presentations is the following: John Palmer mentioned that we should price each piece to be self-sufficient. Ken McGee mentioned their inforce pricing technique and said that this product invites gain and loss analysis by source. In fact, proper management involves knowing the source of your gains and losses within your Universal Life product, and hopefully, we can find time somewhere down the road to avoid allowing the whole thing to get mixed up in our total inforce portfolio and to have some knowledge and control of our destiny.

Another thing that occurs to me - in terms of Universal Life and its unbundling - is that we now have a very unique marriage between the insurance and investment people which hasn't frequently existed within our companies and, furthermore, as actuaries, we have an opportunity here to eliminate the black box syndrome with which we've long operated. Given proper thought, you can easily communicate this product to your non-actuarial friends in your organization and, I think, in the process strengthen your own position as a member of that management.

One of the more interesting subjects about which to theorize, yet one of the more agonizing practical subjects, is the replacement problem; that is, the phenomenon of agents replacing our own business with our own new Universal Life plan. Key issues enter this thought process, including whether you want to take an active or a passive role, in other words - do you let it happen to you or do you devise a program to deal with it. How do you handle agents' commissions on change-of-plan? What do you do about asset transfers if you're working in a subsidiary environment? What kinds of interest credits are appropriate to transferred funds? How do you load the transfers? How do you manage the aspect of premium taxes on change of plan? What would be your GAAP treatment? With that general background, I'd like to ask John Palmer to start us off.

MR. PALMER: As I mentioned earlier, internal replacement was a major concern to us when we started down the path to developing the Universal Life product. A career salesforce, especially one like ours which evolved from a debit background, is strongly conditioned towards servicing and continually upgrading its existing customer base. Universal Life is, of course, extremely easy to use for replacements, since nearly any amount of existing values on old policies can be rolled in. We responded, as I said, by restricting the policy size in order to avoid a large portion of the markets where policies were inforce. In conjunction with this, we installed a rather severe commission adjustment scheme, drastically reducing the already lower commissions to very low levels, unless certain criteria for increase in both face amount and premium level were met. As more and more companies entered the market with small face amount policies, we found it no longer possible to ignore a major market segment. We introduced several policies with lower policy size limitations to meet head-on with the newer policies in the market, but at the moment our approach for this smaller policy series is to pay only renewal commissions on sales to any existing policyholders. This, as you can imagine, is not very popular with the salesforce. A revision of these rules is currently under way to produce a grading off of the commission chargeback as a function of the relative size of the policies and of the age of the replaced policy. The trick here seems to be to apply the commission brakes in such a way that field discomfort and the rate of self-replacement are both kept within tolerable bounds.

Several practical problems occur in framing any such scheme as this. First, comparing the size of the replaced and the replacing policies is somewhat difficult because of the flexible nature of Universal Life. One would like to use the new premium stream but it is not really known. Second, substantial initial deposits, whether from rollover from existing policy values or from other sources confuse this matter even further. Third, the typical replacement definition, for example lapse and issue within six months of each other, can be circumvented by borrowing from all policy values without actual lapse until beyond the test period. Fourth, since it is quite common for Universal Life to be administered by a system separate from the company's mainstream system for its traditional business,it may be difficult to detect replacements which are not reported by the agent. A bright side of this, of course, is that with the Universal Life line, a company at least has a means of protecting its own block of business from the inroads of outsiders. In fact, a number of companies - ours included - will waive the usual replacement commission adjustment rules where there is in fact a clear case of replacement in self-defense.

Perhaps the moral of all of this is that each company must consider carefully the nature of its own exposure, the character of its distribution systems and its market segments, the competitive pressures it expects to face and, last but not least, its administrative capacity. On this last point, there is no sense in prohibiting something that you can't detect nor in using an adjustment formula whose elements are not readily available. Your administrative burdens will be heavy enough without unnecessarily bringing more upon yourself.

MR. BOOTH: Thank you. Arnold?

MR. DICKE: If you're selling Universal Life through a subsidiary, replacement causes asset transfers, and if you have to transfer cash to keep an immunization program going, pressure can be put on the parent's portfolio rate. So it becomes important to control replacements.

One approach is to have a special Universal Life policy within the parent for rollovers. This is an approach which I think deserves investigation. I don't know of any mutual doing this currently.

What other ways are available to keep cash in the parent? Hopefully, while going through the strategic planning process, you were able to think through the whole of what you want to accomplish. If a major objective is to minimize replacements, you have to avoid giving the impression that you are abandoning your old policy line. It's important that you put emphasis on your traditional products and on improvements to those products. Otherwise, the field force reaction is likely to be: "Are these products going to be maintained or are they now "passe?" You have to carry the message that you want to carry, which is, you intend Universal Life for new market and new sales and not as a replacement vehicle.

Commission adjustment programs are another approach, an approach that actuaries always think and preach to the Marketing Department about. Unfortunately, the evidence is somewhat ambiguous. It's certainly true that if you have a stiff adjustment program, you can reduce internal replacements. But the question is, have you saved the policies, or have they migrated to some other company? You have to answer this from knowledge of your field force and its degree of loyalty. Some companies have found that if the replacement policy is not terribly strict, total replacements will still be up, but not as much as internal replacements. In other words, you may be catching some of the business that would have gotten away otherwise. It's a delicate judgement. However, chances are that some form of commission adjustment program is essential to keeping rollovers within bounds.

MR. MAGEE: I am not going to speak at great length about internal replacement despite its being quite possibly the most interesting - and isn't that euphemistic, problem that we face with respect to our whole future course. My company allows but certainly does not encourage internal replacement, although we're not nearly so savage about it as John's company. We charge full first year loads, we request some evidence of insurability and level and/or reduce commissions depending on the duration of the replaced policy. The result of this has been very, very little internal replacement activity with the corresponding expected result, I assume, that most of the business that we've lost has, in fact, walked out of the door and down the street. One of the problems, of course, with internal replacement is the need to - at least notionally - liquidate portfolio assets.

MR. BOOTH: I had promised myself that I would summarize after each of the major topics. I find it difficult to summarize after this one, except to say that it's probably appropriate to do unto others before they do unto you. In other words, when you go to market with a Universal Life product, have in mind a replacement answer instead of merely throwing your hands up in despair when the agent asks the question.

The final topic on our program is one that we approached with some sense of uncertainty. When we were putting this program together, it was about TEFRA time and certainly it seemed any Universal Life panel ought to address the tax environment. We held that in abeyance until breakfast this morning and at that point enlisted the services of two of our panelists to make some brief remarks. I will start with John Palmer.

MR. PALMER: My remarks will address primarily the future outlook as it may affect Universal Life. I assume that most of you are already familiar with the pertinent provisions of TEFRA from your reading of it or from the numerous conferences and seminars now being offered on the subject. In fact, there are some sessions here tomorrow which I assume will go into the details and implications of TEFRA insofar as they're known. There are, of course, unclear portions of TEFRA and work is now proceeding to insert clarifying explanations in the final report on the Act which will serve as the basis for future regulation.

Of particular interest to Universal Life writers and to their systems people are the clarifications of the section 101 (f) requirements relating to the guideline premium and alternative cash value tests. A particular problem there is the treatment of increases and decreases. A group working under the ACLI tax Steering Committee is nearing completion on a project of developing questions and answers for the ambiguous portions of that section, and I think that some workable procedures should result.

Looking ahead a bit, let's consider the present situation that we find ourselves in. The stopgap provisions of TEFRA are set to expire at the end of 1983. If they are allowed to expire, there will be a substantial increase in company tax and, of course, in government revenues. Thus, a simple request for an extension of stopgap for another year or two, say, to allow for adequate time to develop a permanent solution, will be viewed as a request for tax reduction in 1984 and perhaps beyond. Contrast this with the industry's position in getting TEFRA through where it was in effect offering to increase its taxes. Further, there is currently a widespread tendency in several levels of government toward deregulation and re-regulation, all with a goal of achieving a "level playing field". There is little patience with those who attempt to attain a position on the pitcher's mound. This attitude will make it quite difficult to limit development of a permanent solution to life insurance company considerations alone. Efforts will be made to consider the policyholder's tax burden or the absence thereof as well. Already mention has been made of a proxy tax concept, whereby the tax escaped by the policyholder will be collected at the company level. Still further, the concern over insurance taxation may not necessarily be limited to life insurance companies. Witness Senator Dole's press release of October 8 calling for the Finance Committee and Joint Committee on Taxation staffs to report on options for a comprehensive revision of taxation on all insurance companies, and for the GAO to prepare a report on the taxation of property and casualty companies.

What does this portend for the future? If anything like this extended view of the playing field prevails, a permanent solution by 1984 seems highly unlikely, and a fairly drastic change in level and distribution of the tax burden is quite possible. The proxy tax notion would produce some particularly unpleasant results for traditional non-par insurance which even under stopgap have no tax burden on policyholder benefits. The industry will have to fight hard to preserve the advantages it presently has and to counter the view held by some that it is just another investment whose buyers and sellers should be taxed as those buying and selling the investments of any other financial institution. As a starting point, the ACLI Steering Committee has decided to use stopgap as opposed (say) to developing a completely new approach. This does not, however, preclude some fairly major changes, such as going to a single phase system. Presumably, the single phase would be a gain from operations base. At the same time, however, it has been decided to start conversations with Treasury and congressional staffs now rather than wait until a full-blown proposal is ready, as was done before. Thus, it would seem unwise to count heavily on a continuation of stopgap or to count on the tax burden imposed on Universal Life by stopgap as the worst that we can expect. Long range planning in this kind of environment is nearly impossible.

Now, even more than during the development of stopgap, the industry must stick together. Continued intramural quarreling would be very dangerous indeed. I might note that the ACLI Steering Committee has now adopted the position that its meetings and those of its deputies' groups will henceforth be open meetings except in special circumstances. I would urge those who can to follow the proceedings carefully and contribute where possible. We'll need all the intellectual help we can get now and all the political muscle we can get later.

MR. BOOTH: Thank you. Arnold?

MR. DICKE: I just have a couple of quick remarks on the effects of TEFRA on Universal Life policies. Policies that have already been issued-policies that were built on a pre-TEFRA format-will have to be amended to take account of guideline premiums limitations and to avoid the sudden loss of life insurance status. The worry is that policyholders will inadvertently put money in and exceed the guideline premiums. An amendment that prohibits such excess premiums seems capable of solving this problem.

A second point is that because of TEFRA, parent company Universal Life products suddenly have become possible even where the parent was formerly Phase I. Such products may not be quite as competitive, but the differential isn't as dramatic as it would have been under a Phase I situation.

Third, you must determine the impact of TEFRA on any co-insurance arrangements which might have been in use. First of all, of course, the new dividend rule for coinsurance makes arrangements which are based on dividend transfer via experience refund formulas ineffective. Of course, with stopgap in place, that's not too serious, because the dividends end up in a company that's still relatively favored. But if stopgap were to expire, the new treatment of dividends could be very significant. Also coinsurance among related companies is now subject to regulation by Treasury.

An important question that wasn't addressed in TEFRA was the question of indexation: Whether or not indexing of excess interest has any impact on whether it will be vested as a dividend. TEFRA contains one hint, in that when so-called qualified annuities make use of a "formula" or index, they receive favorable treatment.

Over all these remarks hangs the impermanence of stopgap and the question of how to treat an uncertain tax environment in pricing. This is a very, very difficult question, not only for Universal Life, but for all products.

MR. CODY: I'm Don Cody and I want to make some comments as a member of the C3 Risk Task Force. This is a very interesting and important product and I must congratulate the panel in doing a very fine job in presenting the various aspects of it. It's important because it's selling in such volume and it's interesting because it unbundles the various elements of risk and, from the standpoint of the C3 Risk Task Force, it makes it possible for us to study the unbundled investment element which depends so much on the effect of the variation in the interest environment, which is the C3 risk. The C3 Risk Task Force was formed really as a result of the NAIC's Technical Advisory Committee on dynamic interest being unwilling to accept the dynamic valuation statute unless the Society of Actuaries and the Academy of Actuaries undertook a research effort and developed educational materials and eventually made it possible for the valuation actuary to put a value on the capacity of the company utilized beyond the statutory valuation reserves-statutory valuation reserves complication in which they're developed for the Universal Life are going to be essentially the accumulated cash value, I guess, if that's been calculated properly. At the time the Universal Life was introduced, the environment was a high variable interest environment; that, of course, gave rise to the valuation law too. But the contract was designed as I see it in order to make it possible for insurance companies to compete with investment vehicles. In this kind of market, and because of the volatility and the size of the industry, short-term investment plans have been used. This is true of the deferred annuity as well. As a matter of fact, at the beginning it looked as if the two contracts were the same and they weren't sold too differently in some circumstances. TEFRA has now separated them very nicely. These risks of course exist with these kinds of contracts. This is not intended to single out the Universal Life, simply, you can see it better. But perhaps more importantly, in unbundling the investment vehicle, you've also unbundled the risk and this is quite clear to the buyer. You therefore, I think, can expect somewhat more sensitivity to the interest environment on Universal Life than on conventional life products. I think the problem is that interest rates are now falling and the inverted hill curve has gone away and there must be a great temptation to lengthen the assets. And if the assets aren't lengthened, then it's going to be hard for the Universal Life to compete as well as it had with outside investments that are invested somewhat longer. If you lengthen the assets, and the curve changes, or if the interest rates go up you're essentially going to have to sell the assets or borrow from elsewhere in your companies in order to make up the difference and this will constitute a problem of supporting the interest credited. I assume, by the way, that you have segmented assets plus an IYM system on top of it or some surrogate of that in order to run a Universal Life line. The trouble is, that if you lengthen the assets, and the interest rate goes up, you're going to have investment losses which will make the contract less competitive, and you'll probably keep it competitive and that will bring the loss to your bottom line. If the interest rates fall, your short-term assets are not going to be very attractive in this type of investment contract. At any rate, this is the environment that's being studied by your C 3 Risk Committee and, as far as we can see, the only way to determine this risk is to run scenarios. In other words, for a pricing actuary, this means "How much risk charge should I have?" I think that you'll probably get that by looking at a variety of scenarios. To a valuation actuary, it means "How do I determine what amount of surplus I can represent to the insurance department in my role as valuation actuary on top of the statutory reserves?" I know that everybody that has gone into the Universal Life has been concerned about this problem; what I relate is no surprise to anybody, but my purpose in standing up is to say that it would be very wise to set up systems to determine this because looking down the line a few years, we as actuaries are going to have to put measures on it. Of course, this is important in determining whether or not, how much profit you're going to make and what your financial planning is like and should be like today. The question is, if any of you have done this in great detail, we certainly would like to know about it, because we have great humility in this area. Thank you.

MR. BOOTH: Thank you, Don. Your comments are very much appreciated. Any response from the panel?

MR. DICKE: As I mentioned in my presentation, we've taken the matching of assets and liabilities very seriously. We're attempting to have the liability and asset cash flows match up. We are not merely immunizing, but actually matching as far as we can. If interest rates fall, we may see a certain amount of surrenders. That underlines to us the importance of Universal Life II, which will have multiple funds and will allow people to invest long-term if they wish, bearing the interest rate futures risk themselves.

MR. CODY: I really shouldn't stand up again, but I forgot to mention when I was making my remarks, that the lapse function which is hard to define but essentially has to do when you have a negative inflow or a positive inflow is very much determined by how you handle the contract which in turn depends upon the interest environment. On this variable contract, there will probably have to be a security.

MR. BOOTH: There certainly would be, yes.

MR. STERN: My name is Larry Stern, I am from Durham Life Insurance Co. My question, or at least a challenge to the panel, is like this. Major emphasis that we've heard today, and also major emphasis of the marketability of Universal Life products has been centered around the ability to credit high interest rates on a permanent life insurance type product. The introduction of such products up until the mid-point of this year did indeed place a great deal of importance on the payment of high current interest. From the development of the Universal Life product at our company, the pressure to credit high rates of interest does reduce the margin for profit to be gained from investments. Therefore, most of the profit comes from the mortality element; as we saw in our asset share testing, 70% of our profit does come from the difference in the credited or the chargeable mortality rate, and what your underlying company experience rate is. If insurance rates return to somewhat normal levels, and we find ourselves forced to reduce the interest rate spread to continue to credit the higher rate of interest, more and more attention will be placed on the risk charge element, with pressure to reduce it, as has been done in the ART area. If indeed this is the major source of profit, do you plan to respond to this pressure by lowering risk charges or turn to other sources for profit, such as reinsurance allowances as was done in the ART environment.

MR. BOOTH: That's a lovely question, Larry. Who would like to lead off?

MR. MAGEE: I'll start, and possibly summarize my entire answer by saying that we have no intention of losing money on this product, whatever happens. To some extent, I think the sharp drop in short-term interest rates which has been reflected in what most companies are crediting in their Universal Life is probably a good thing; as you say, a lot of it was sold during the the summer at very high interest rates; there was a kind of euphoria involved in it. I think this sharp drop, which I feel is temporary, will alert the marketplace to the fact that this really is a flexible contract rather than a high interest contract and that it's the flexibility that probably will provide the street durability of it. A drop in the interest spread and/or, as you say, resulting pressure to drop the profit to be made on mortality is a temptation, but I have to hope that we can resist that. I don't want to see another ART emerge out of Universal Life.

MR. BOOTH: I hear a plea of sanity here. Anyone else? Andy?

MR. BODINE: Andy Bodine, Interstate Insurance. I just wanted to speak to the asset side a minute on a couple of thoughts we have had. I agree with Arnold's comments about the importance of considering the asset segmentation, we have a portfolio approach and we are working very hard on segmenting the cash flow and keeping good track of your yield. One point that bothers me is how to express capital gains and losses as a yield equivalent. Assuming they're not insignificant, it's entirely appropriate to credit them immediately or to ignore them. And the next questions is, what else to do and I think I've done a little numerical analysis that works out to amortization over a period. It satisfies me, but that's fine for simple, easily measurable basic corporate bonds. The other side is our investment man wants badly to get us into some investments which he feels are excellent for the company as a whole, but I've restricted his use of those for the Universal Life product because they're not directly measurable. Maybe I'm taking things like the oil deals, or real estate trusts, or convertible bonds, or any of a number of things which, based upon his investment analysis, are good in the long run for the Universal Life policyholder but how do you convert the potential yield or whatever it is into a measurable yield. I guess that, having expressed those thoughts, I'd love to hear some comments on what maybe some people are doing in this area.

MR. DICKE: There are always ways to analyze investments that will give you a rate of return. I assume when you're talking capital gains, you're talking about unrealized future capital gains on bond discounts or the like. Whatever the investment, there are ways to express a yield rate. I have more of a problem with the appropriateness of the investments you're talking about. You certainly can't do a matching strategy using longer term investments of that kind. If you don't, then in my mind the real question is in what way are you going to reserve for future changes in interest rates? I think that is what Don Cody was referring to before. Putting a rate on such investments is one thing, but I think the real question is: shouldn't you be throwing up an extra reserve if you're going to take fairly big risks in your investment procedures?

MR. BOOTH: Back to the question pushed by Larry Stern. It occurs to me, after thinking about that some more, that there needs to be some consistency in the three elements or the three sources of profit in your product. The fear that Larry expresses may be a call for us to exercise some sanity in matching our expenses against our expense charges, our investment component and our mortality component. Relying solely on one element for the majority of our profit may not, in the long run, be a wise thing.

MR. SILKS: Larry Silks, National Benefit. Since Universal Life is a unique product, have you designed any unique illustrations for the agents or are you just using your traditional net cost illustrations or asset accumulations? Specifically, I am interested in Penn Mutual; your company is more closely akin to mine.

Our illustrations show the run-out of the policy over a number of years, on a guaranteed basis and on the current basis. There is a choice of current interest rates they can use... So basically you're assuming that the contract is basically the same contract, only it has an extra feature; there's nothing unique about Universal Life in that sense. I guess you could look at it that way. I'm not sure...nothing unique about it. I guess you could say that, except for the fact that, of course, you can choose to look at a number of different yield rates, and compare, and actually the agents have tended to be conservative in what they look at because - at least from the ones I've been able to tell, they are aware of the problem that you might not be able to realize some of those rates in the future, maybe more aware of it now than they were in the past.

MR. BOOTH: As the moderator, I would like to express my appreciation to the panel: Arnold, Ken and John.