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UNIVERSAL LIFE

Moderator: DANIEL F. CASE. Panelists: CHRISTIAN J. DES ROCHERS, HAROLD LEFF, JAMES M. ROBINSON. Recorder: WILLIAM CARROLL

°Are there any new product design features?

°What are the principal computer systems problems in the administration of universal life?

°How will companies cope with the Internal Revenue Service's excess interest ruling? Will profit margins be reduced? Can reinsurance minimize the effect of the ruling?

°Will the limitations on gross premium and amount at risk affect the marketing of universal life?

°What are the prospects for early issue of universal life policies whose values are tied to the investment experience of separate accounts?

°Are companies adjusting reserves per Internal Revenue Code Section 818(c)?

°What minimum reserve and nonforfeiture standards are being established?

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

°What are some of the special considerations for mutual companies in connection with universal life?

MR. DANIEL F. CASE: We have a fine panel today. First we will hear from Chris DesRochers, who is Actuary with the consulting firm of Milliman & Robertson. Chris is engaged in many aspects of the life insurance business. He was formerly at Hartford Life Insurance Company, where he was prominent in the development of that company's universal life product.

Next we will hear from Jim Robinson, who is Financial Actuary--Domestic Life and Health with Sentry Life Insurance Company. Until recently, Jim's assignment was individual life and annuity product development and control for the U.S. business of the Sentry group.

The third panelist we will hear from is Harold Leff, who is Actuary with the Metropolitan. He works on pricing and product development for individual life and annuities.

MR. CHRISTIAN J. DESROCHERS: Nearly two and a half years ago, although it seems much longer than that, I attended a seminar at a large, southeastern actuarial consulting firm, whose name escapes me at the moment, on non-traditional products. The product which was of the greatest interest to those in attendance was a relatively new product called universal life, which was pioneered by the firm and offered by four or five companies. At

that time it seemed fairly easy to assemble all the conventional wisdom within the industry regarding the product into a notebook or two. Certainly, times have changed since then!

Universal life is now a significant part of the product portfolio for a great many companies. Within the last couple of weeks, the New York Insurance Department has begun approving universal life forms. As a result, the product can now be written in one form or another in all states. In the last two and a half years there has been a great deal of creativity in product development, and a wide spectrum of universal products introduced to the market place. This morning I would like to share some thoughts with you concerning the direction of that development, where it came from, and where it is likely to go in the future.

Broken down to its simplest basis, universal life has eliminated the concept of "plan of insurance", and, through the computer, coverage has been unbundled into "protection" and "savings" elements. This has worked reasonably well from the consumer's perspective, but has been much more difficult to accomplish from the perspective of the agent, or in more general terms, of the distributor of insurance products. Historically, commission philosophy has not been consistent over the range of traditional plans: compensation on permanent products has generally been greater than that available on a combination of term plans and annuities. In considering the level of compensation appropriate to a company's universal life, it is important to focus on the segment of the product spectrum in which the agents will perceive it to belong.

Since the initial universal life offerings, a steadily increasing trend in both the compensation and expense loading seems clearly identifiable. At the same time, there is some movement away from the early commission and expense patterns. In their place have grown structures which have tended to parallel traditional patterns more closely. This trend toward increasing compensation for universal life products appears contrary to the long-term trends in the industry toward lower compensation, and the ultimate compensation level for universal life, as well as other products, is still open to speculation. It is clear, however, that compensation on universal life exhibits a much wider variation than found on traditional products.

Another characteristic of the early universal life products was a general matching of first-year expense charges and commissions. The very first universal life product was characterized by a low surplus drain, with most of the first-year commissions funded from the first-year charges. More recent products appear to require a greater company investment, but are still characterized by a correspondence between first-year commissions and expense loads, as to both pattern and amount.

The traditional first-year expense pattern is expressed in terms of per-thousand and per-policy components. A significant number of universal life plans still follow this pattern. Per-policy charges seem to vary in a range from $50 to $600, and per-thousand charges seem to vary over a corresponding range of $.50 to $2.50. Average values would be $250 per policy and approximately $1.50 per thousand.

For these plans commissions are generally expressed as a per-policy and a per-thousand amount, often related to the level of the first-year expense charges. An approach which seems to be gaining in popularity expresses commissions as a percent of a target or a minimum premium. In this structure, a traditional level of commissions is paid on premiums up to the target or minimum level, and a renewal-type percentage is paid on the excess. Under a minimum-premium structure, the amount of premium on which a high first-year rate is paid is generally tied to the minimum amount required to keep the policy in force one year. The target-premium structure is slightly more flexible and often will be designed to accommodate actual premium payments less than the target level. This method retains many elements of the traditional compensation pattern, although the actual commission is dependent on the level at which the target or minimum premium is set. These methods in fact may not result in any greater commission dollars being paid to the agent than the traditional pattern, and in some cases may pay less, but they have the advantage of being familiar and comfortable to much of the field force.

In our initial design, at my former company, we felt we did not focus enough on the way in which the commission structure would be communicated to the agent. I think that the product changes that we have seen have addressed that problem. One of the real needs in the universal life market was to enable the agent to estimate what his own compensation would be.

At the same time that the target-premium concept is gaining popularity, there is a trend toward the use of rear-end expense loads. Back-end loads have been used in concert with a front-end load to allow the recovery of additional acquisition expenses, or they have been used on a stand-alone basis. To comply with requirements for minimum cash values, these rear-end charges must become less by policy duration. Recently, there has been a great deal of interest in these product designs, particularly here in the midwest.

Excess-interest surrender charges (as rear-end loads) have generally been acceptable to state regulatory authorities. There are, however, an increasing number of states, including New York, Georgia, and South Carolina, which currently limit such penalties. Additionally, these have proved somewhat difficult to administer, and do not appear to be as popular as they once were.

A popular renewal expense charge is one not often directly identified as an expense levy. This is the use of a lower interest rate on an initial layer of cash value, where the initial layer is commonly $500 or $1000. The use of a split rate on excess interest gives the company an expense allowance which is normally sensitive to inflation. There have been a number of products introduced which provide for excess interest on the entire cash value. This can be seen as a response to some criticism last year in the area of interest rate advertising.

The cost of insurance is a principal source of profit on most universal life plans, and typically it has been set at a level above term rates found in the very competitive segments of the market place. A significant competitive development in many of the products introduced in 1982 was the use of smoker/nonsmoker mortality charges. The use of a nonsmoker scale provides

a distinct competitive advantage in universal life cash value comparisons and creates a corresponding disadvantage for companies maintaining an aggregate cost of insurance where a sale is to a nonsmoker.

Another area receiving attention is the use of a select and ultimate rate scale or a variation thereof. The principal limitation on the select and ultimate scale is the importance of the cost-of-insurance component as a source of expense recovery and profit. The margins available under such a scale are likely to be lower than the comparable amounts under an aggregate plan. A variation on this is a one-year select rate with a target-premium approach. From the company's perspective the allocation between cost of insurance and expense load is artificial, and a one-year select rate can often simplify the expense structure. This can also allow for a low first-year target premium. On the other side, however, it may cause some difficulties in terms of the annual reporting to the policyholder if, indeed, the policyholder really pays attention to the statement sent to him.

Some states have raised questions as to the proper method of handling guarantees of the cost of insurance, particularly for smokers and nonsmokers. Under the generally accepted method by which compliance with the nonforfeiture law has been demonstrated for universal life, the maximum rates guaranteed for standard lives are limited to the 1958 Commissioners Standard Ordinary (CSO) Table. Because of their higher mortality assumption, smokers' rates may exceed the 1958 CSO rates. In this instance the only practical way to accommodate smokers is to establish them as a "substandard class", which has negative implications for marketing. While companies maintaining smoker rates within the 1958 CSO can solve certain regulatory marketing concerns, they may be forced to compromise profitability or reduce the margins available for future changes in the smoker rates. There has been some activity recently in developing smoker/nonsmoker rates based on the 1980 CSO Table, and this may solve some of the problems.

Although a large number of states have adopted the 1980 amendments to the Standard Valuation and Nonforfeiture Laws, permitting the use of the 1980 CSO Table, it is expected that many companies will remain on the 1958 CSO as long as possible for universal life. There are higher margins available with the 1958 CSO when it is used as the basis for the maximum rate guarantee, and there is a higher per-thousand component in the expense allowance in the nonforfeiture test. Unsubsidized, non-substandard smoker rates would be virtually impossible to maintain within the 1980 CSO rates. There are some companies, however, who are considering the use of the 1980 CSO as the basis for their universal life product.

An additional concern which companies should keep in mind is that in states allowing a plan-by-plan implementation of the 1980 CSO Table there is often a requirement that once you have introduced a 1980 CSO plan, all new plans must also be based on the 1980 CSO Table. So, for those companies considering universal life, the timing of introducing other products based on the 1980 CSO may be critical. It may be important to get a 1958 CSO universal life out first and then work on a 1980 CSO product.

One of the new features of nearly all the new universal life contracts is the addition of characteristics required for compliance with Section 101(f) of the Internal Revenue Code. Section 101(f), as established by the Tax Equity and Fiscal Responsibility Act (TEFRA), provides favorable tax treatment at death for contracts meeting its requirements. Two bases of compliance

are allowed for universal life contracts. The first provides for a limitation on premiums in combination with a minimum amount-at-risk corridor. This is often referred to as the guideline premium limitation. The second test, sometimes called the cash value test, provides a limit on cash value equal to the attained age net single premium per thousand for the current death benefit.

The guideline premium limitation was intended specifically for universal life contracts, and the great majority of universal life contracts seem to follow this method of compliance. The cash value test was intended principally for traditional adjustable life plans, although it has been used for universal life as well. In the case of at least one company following this test, however, the death benefit is limited to a level amount, which is often characterized as an "option A" death benefit.

Beyond the specific product features which characterize universal life plans, there are some additional developments appearing in the marketplace. It is becoming increasingly common for a company to offer more than one universal life policy, although there may be some state-mandated restrictions on the availability of two products in the same marketplace. The use of multiple products may be motivated either by the desire to have varying levels of compensation or by a desire to have additional products available for specialty markets such as pension trust and salary savings.

A large reinsurer is currently in the process of setting up a service bureau for universal life products. They would provide administrative and data processing work on an ongoing basis for companies who do not have the internal resources available to develop and administer a universal life product. They are currently recruiting companies for the pilot phase of the program, and they hope to offer it on a wider basis within a short period of time.

As a final comment I would like to offer an observation which a number of people have shared with me: that is, it appears that at least in the first few months of 1983 the rapid entry of companies into the universal life marketplace has slowed somewhat. At the same time there appears to be an increase, especially here in the Midwest, in interest in "irreplaceable life"-type products. Whether this is a short-term trend or the beginning of a long-term trend is something I will leave to speculation. The recent actions of the New York Insurance Department will allow domestic New York companies to market universal life for the first time. This may lead to some increased pressures on other companies to introduce the product.

MR. JAMES M. ROBINSON: My company, Sentry Life, has been selling universal life since April of 1982. Our product, which we call Comprehensive Life, is a generic flexible-premium adjustable life policy with conventional expense loadings. Distribution is accomplished through an all-lines captive sales force and via general and independent agencies. Commissions are designed to match the form of the contract expense loadings. Individual life sales for the first quarter of 1983 were more than double that for the same period of 1982. Comprehensive Life has become the largest selling individual life contract in Sentry's portfolio in less than one year.

The success or failure of a product such as universal life is very much a function of the capabilities of the administration system. The same flexibility that facilitates sales creates nightmares for system programmers. Unconventional commission structures call for irregular commission systems.

Comprehensive disclosure requirements generate substantial sections of program code in support. These problems are not new to the insurance industry, but it has been rare to observe so many complications in one product.

Flexible premiums, adjustable coverage, partial withdrawals, policy loans, indeterminate mortality charges, and excess interest credits create a number of challenging systems problems. I will discuss some, but by no means all, of these.

The primary concern of the administrative system for this type of policy is to audit and record properly the various ongoing adjustments to the policyholder's current cash value and death benefit. Policy service correspondents must be able to assess a contract's status immediately and screen policyholder requests for changes in order to prevent inadvertent lapsation, anti-selective changes in the amount at risk, and possible Section 101 disqualification. This will usually be feasible only with on-line inquiry and processing systems.

In part in order to alleviate this problem, some contracts limit the frequency of allowable policy changes or postpone such changes until the next policy monthaversary. Batching adjustments each month will still require, however, that the system store all unprocessed requests and inform policy service clerks of the status of these pending transactions. Audits on proposed changes must be performed at the time the request occurs, not when the adjustment is actually applied.

The unbundled nature of the cash value development will undoubtedly generate frequent questions from policyholders on the history of additions and deductions from their policy values. In order to handle these inquiries efficiently, it will be necessary to store as much of the policy transaction history as possible on the system. This requirement will also facilitate the production of annual reports and the analysis of product lapse and mortality experience.

Another eventuality that must be provided for is transaction reversal. The administrative system should be able to erase the cumulative effect on the current cash value of any erroneous past increment or decrement. This will probably require that the system rerun all the monthly processing since the effective date of the reversal. A likely example of this problem is seen with retroactive waiver of monthly deductions for the waiting period of a disability rider.

The ability to add coverage after issue mandates that the system keep track of these layers separately. Each layer may have its own underwriting classification and rating. All transactions must be allocated in some fashion to these segments in order that the cash value, amount at risk, and mortality charges may be properly calculated for each. To simplify this aspect of the programming, Sentry has resorted to a melded mortality charge similar to an approach used on adjustable life contracts involving some substandard basis. A set of weights indicating what percentage of the amount at risk corresponds to what mortality class is maintained in the system. These weights are adjusted upon increases in coverage and are kept constant until the next increase. Thus, decreases are assumed to arise proportionately

from each existing layer. This approach allows Sentry to avoid maintaining separate records for each policy segment. Most other companies writing universal life add new records for coverage increases and use a last-in, first-out allocation for subsequent decreases in coverage. These companies face the additional problem of assigning premium received, withdrawals, etc. to the various records in the system.

Universal life presents some interesting interest-crediting problems as well. Many of these contracts pay excess interest on only the unloaned cash value in excess of some stated amount. This requires the system to check the outstanding loan balance constantly in order to credit the proper interest rate to the cash value. Timing problems arise at contract issue and when interest rates are changed. Backdating policy issues may generate windfall interest credits to the policyowner. Sentry starts crediting interest as of the effective date on the initial premium and on the date received for subsequent amounts. So, any difference between the issue date and the date the first premium is received presents a problem. Sentry's system uses the effective date to determine which interest rate to credit to a policy when different rates are being used on different generations of the contract. Effective date criteria can present a problem for large contracts in underwriting at the time of the rate change. Some companies will not date a large policy until the underwriting is completed. So, even if the premium money is available prior to an interest rate reduction, large-policy applicants may not be able to lock in the higher rate, because of the selection delay. There are only a few of the types of interest-crediting problems encountered with this policy.

Since the policy values of universal life are not predetermined at issue, a variety of presentations have been developed for applicants and policyholders in order to project future values and to summarize past development. The problems faced by the system programmers differ for these two cases.

Annual reports are required by the terms of the contract. To support this presentation the system must maintain a history of transactions to the cash value for each month within each policy year. State insurance departments vary in the required data to be disclosed, so some variation by state in the data to be stored may be necessary.

Proposals and disclosure forms at issue and reproposals after issue require that the system model the product and simulate the future development of cash values and death benefits. The programming must, therefore, accommodate a wide array of possible scenarios for future premiums, withdrawals, coverage amounts, etc. In addition, most proposals allow the applicant to solve for one of these items, given that the rest are set. This will require the system to search iteratively for a solution that generates some target value. Proposals run from a large mainframe system can quickly find these values, but proposals requested from micro-computers can take substantial amounts of time in performing this task. The processing time cannot be reduced beyond a certain point without changing the structure of the contract.

An additional area that complicates the administrative system is presented by the Section 101 qualification standards for flexible-premium adjustable life contracts in TEFRA. Two options are available: one designed for adjustable life policies and one for universal life contracts. The

universal life tests examine two aspects of the policy. First, the death benefit at any point must always exceed the cash value by a stated percentage, which is graded by attained age. In addition, the sum of premiums paid into the contract may not exceed what is called the Guideline Premium Limit. The limit at any duration is the greater of the Guideline Single Premium (GSP) and the sum of past Guideline Level Premiums (GLP). The GSP and GLP are calculated at issue and are based primarily on guaranteed policy benefits and charges. These values are to be recomputed after issue when changes to the contract parameters are made. The formulas for these items are briefly described in the legislation, and there is plenty of room for reasonable interpretation.

The death benefit restriction is solved by most companies by amending the policy form to incorporate the required margin. The premium limitation, however, has significant effects on the administration system. First, the proposal process should be modified to indicate at least where potential problems may exist. This might range from merely marking such durations to displaying the entire projected schedule of premium limits by duration. The second area affected is the issue process. When the policy is booked, the only data generally coded to the system are the initial premium, the scheduled premium, and the initial coverage. So, the proposal that sold the case may not have indicated any compliance problems, since it may have been run with a decreasing renewal premium schedule or an increasing coverage schedule, but the system at issue is ignorant of these anticipated adjustments. Consequently, tests for projected compliance at issue may indicate future problems where the proposal did not.

In addition to these two areas the system should check the effect on compliance of policy changes after issue. Reductions in coverage or increased premium payments can both cause problems. Such changes should be audited before being processed, if possible. The billing system should be modified to prevent "bills" for premiums which would disqualify the plan from being sent unless such a payment is necessary to keep the policy active. The annual report process should check for any overpayment in the latest policy year and make an appropriate adjustment within the next sixty days. In addition, the annual report should indicate whether a problem may develop in the next year.

Sentry currently audits at sale and issue. A utility program is also run against the inforce each month to check for short-run problems in complying with Section 101. As soon as more definite formulas are developed for the calculation of the GSP and GLP, specifications will be drafted for changes to the remaining portions of the administration system.

Sentry pays commissions expressed as per policy, percent of premium, percent of low cash value, percent of first-year mortality charges, and percent of post-issue coverage increases. The percent-of-premium and mortality charge components are annualized at issue, and a commission chargeback is triggered if premiums or mortality charges vary from those used in the annualization formula. Needless to say, none of these developments were anticipated in our old commission system. So, Sentry and many other companies selling this product have made significant changes in these systems as well.

The unique features of universal life affect many other components of the system. Maintaining a usable data base for performing persistency and mortality studies will be complicated by the ever-changing amounts at risk and by the flexible nature of the premium payments. The valuation of liabilities can no longer be accomplished by applying predetermined reserve factors to the coverage amounts. The cash value must be incremented by expense, interest, and mortality deficiency reserves in order to determine the reserve. Measures must be taken to provide reinsurers with the information necessary to compute ceded premiums and reserves. Finally, all of these components must communicate well with the accounting systems.

The last area within this topic that I would like to touch on deals with the development of these facilities. Sentry began designing system specifications for universal life in the middle of 1981. We decided to construct the system ourselves rather than purchase a system. Our current estimate for completion is July 1 of this year. To allow for the issue of the product in the interim, a stopgap, semi-mechanized system was quickly developed through the joint efforts of Data Processing, Actuarial, and Policy Administration. The Actuarial Department developed the proposal and disclosure systems, while Data Processing merged and expanded the capabilities of our old insurance and fund systems. Most of the monthly deduction processes are done by hand and entered into this hybrid system. This approach has worked well enough to allow us to sell a base plan and a waiver rider. It has also been educational in discovering those system specifications which needed refinement.

I would like to offer a general observation based on this experience. A very long lead-time is needed to develop such a system. So, it is very difficult to make product changes without delaying the mechanization process. Such changes may be made relatively quickly, however, to the interim system. Thus, it becomes very tempting to make changes currently that the permanent system will not be able to support in the long run. Thus, the flexibility of a manual stopgap system may create difficulties when the administrative system is finally mechanized.

To sum up this topic I would suggest, for this product at least, that it is not unusual for the tail to wag the dog.

A primary factor in the marketability of universal life versus more conventional products is the opportunity given the company to reflect current interest rates in the cash value development. For quite some time now the tax treatment of interest credited in excess of policy guarantees has been intensely contemplated. The issue in question is: "Should this excess interest be subject to the same deductibility limitations imposed on policyholder dividends?" The industry has been divided, not surprisingly, on this question between those who stand to gain and those who stand to lose.

Several developments in the last year have provided fuel for the fire. In June the Internal Revenue Service (IRS) issued a private letter ruling to Massachusetts Mutual indicating that excess interest was in the nature of a dividend and subject to similar tax treatment. Shortly thereafter Revenue Ruling 82-133 was promulgated, applying this same interpretation to excess interest under single-premium deferred annuities. Within this latter decision the IRS invoked Section 7805(b) to exclude certain amounts

from this treatment. Included in these exemptions were amounts credited as excess interest on certain life policies. Although no public ruling had been issued labeling life insurance excess interest as a dividend, the position taken in the private ruling taken together with the implication that 82-133 applies to life insurance not meeting the exemption requirements presented a clear picture of the IRS's answer to this question.

Assuming that this interpretation applies as well after TEFRA, universal life should receive an 85% deduction for stock companies and a 77.5% deduction for mutual companies for excess interest credited in 1982 and 1983. For a stock company crediting 10% and reserving at 4.5% this requires a reduction to 9.4% in order to maintain a given after-tax margin. Such a reduction is not desirable, but is certainly more attractive than the drop to 7.5% which would be required in the event that the entire excess is not deductible.

The greatest concern now is the treatment of this item beyond 1983. If deduction is disallowed, I believe that sales will be adversely affected. The impact, however, can be somewhat reduced by restructuring the loads in the contract in order to reduce the current interest rate without adversely affecting the cash value development. Thus, per-policy and percent-of-premium loads might be reduced while the interest margin retained by the company is increased. This would help to reduce the excess interest component of the reserve increase. Even without such changes, I believe that the unbundled structure of the contract provides enough advantages by itself to ensure the firm entrenchment of universal life in the future of the insurance industry.

I am sure that all of you who have been associated with universal life are familiar with the restrictions placed on the premiums and amount at risk under flexible-premium adjustable life contracts by TEFRA. Since I have already referred to the form of these limitations in my discussion of computer problems, I will move on to some of the marketing implications.

The most obvious effect of TEFRA in this regard is the prevention of the use of universal life as an investment vehicle rather than primarily as a mechanism for providing life insurance protection. This, of course, was the objective of the legislation. In addition, however, other marketing uses of this product have been affected by TEFRA's limitations. The replacement of existing permanent coverage through the rollover of the old contract's cash value will substantially deplete the available guideline premium ceiling. Thus, the policyholder may have to reduce the renewal premium level or increase the coverage under the new plan in order to remain in compliance with Section 101. Plans sold to generate a return of premiums within a specified period of time after issue and then continue on in a paid-up status may be difficult to design because of the large premiums generally required. Universal life at young issue ages will mandate large volumes of coverage relative to the premiums paid. Use of universal life as a funding vehicle for college or retirement will also be more difficult than before TEFRA. But even with these restrictions, the marketing opportunities for this contract are substantial.

An interesting scenario that may develop as interest rates fall is complicated by the premium limits. Suppose that a client is sold a universal

life contract based on a proposal which illustrates the payment of a premium close to the guideline limitation. The projected cash value development under current high interest rate assumptions will produce very large amounts as the policy ages. If the policy is sold on the basis of these large amounts, then problems will develop after issue if the interest rate credited is lowered. Since the guideline limitation is based upon policy guarantees, the premium ceiling will be unaffected by a reduction in the current interest rates. But, in order for the client to maintain the high cash values displayed at issue, the current premium payments will have to be increased. Such an increase will probably disqualify the contract under Section 101. Thus, even though the contract was issued with no anticipated compliance problems, the dynamic nature of current charges and credits to the cash value mixed with the static nature of the premium limitations may prevent a client from realizing the objectives which were to be met by the contract. Companies should, therefore, be very careful with sales which are close to disqualification at issue.

A number of imaginative approaches in product structure are possible which may alleviate some of the restrictiveness of the TEFRA limits. Contracts in which the current death benefit is the cash value plus a specified amount will generate a larger premium limit than those where the death benefit is equal to the specified amount. Such contracts utilize the full amount at risk allowable under TEFRA's computational rules. The development of a single-premium version of universal life may provide a depository for cash value rollovers on replacement business which would not be subject to the TEFRA limits, since the premiums are no longer flexible. Specifying an earlier maturity date in a contract will increase the limits. This will provide relief for contracts sold as endowment plans. The shortest duration that can be used in the guideline computations, however, is twenty years. Another approach is to shift the policy loadings away from the interest margins and increase other expense loads. Since expense loads may be included in the premium limit formulas, this will increase the premium ceiling. It will also, however, increase the excess interest credited, which may at some point generate additional taxes. I am sure that there are other ideas which I have not touched upon. As companies gain experience with universal life, such strategies will become more apparent.

MR. HAROLD LEFF: Separate-account universal life, often referred to as "variable universal life" or "universal life phase II", was in the idea stage almost from the time "traditional" universal life hit the insurance market place. Most actuaries envision such a product to work very similarly to general-account universal life, except that the cash value or fund will earn interest based on separate-account performance, rather than based on rates declared by management or generated by an external index.

It quickly became evident that variable universal life was a "square peg" relative to two major regulatory "round roles"--the National Association of Insurance Commissioners (NAIC) Model Regulation for Variable Life Insurance (VLI), and the Securities and Exchange Commission (SEC) rules providing relief for insurers marketing variable life from certain aspects of the Federal securities laws, the most significant of which places limitations on sales loads.

An industry effort commenced at the NAIC level to modify the VLI Model Regulation to accommodate a variable universal type of design, culminating

in approval by the NAIC in December 1982 of a revised Model Regulation. The most significant changes made to the Model Regulation were:

1. Permit a non-level and flexible pattern of premium payments. The prior version limited plan design to those having a level premium-payment requirement.

2. Permit other than whole life designs. While the prior Model Regulation permitted only whole life coverage, universal life designs can provide coverage ranging from term insurance at one extreme to endowment coverage at the other extreme.

3. Eliminate, for universal life designs, the requirement of a guaranteed minimum death benefit. For variable life policies with required and scheduled premium payments, a guaranteed minimum death benefit must still be provided. Such guarantee provides that even if the cash value becomes inadequate because of poor investment performance, the initial death benefit can be maintained by payment of the required premiums. It would be extremely difficult and expensive to define and administer such a benefit in the absence of required, predictable premium payments, and hence, this required provision was dropped for flexible-premium plans.

4. Provide greater flexibility as to the range of investment choices available to the policyholder. One obvious category of investment not available under the prior Model Regulation was real estate, which was expressly prohibited under that Model (unless the real estate was actually shares of a real estate investment trust), primarily because of concerns over liquidity and the difficulty of making daily valuations. These concerns have been addressed appropriately in the new Model, with respect to both fixed-premium and flexible-premium separate-account products.

As of now, the prior Model Regulation has been adopted in about half of the states, including most of the large states. It will be necessary to amend the Regulation in those states before variable universal policies can be sold there. It may, however, be possible for companies to obtain quicker approval to sell variable universal in states which had not adopted the prior NAIC Model.

Turning now to SEC regulation of variable universal life, perhaps a bit of background would be helpful. In addition to the more mundane requirements which the securities laws impose on companies selling variable life policies--such as the requirements for a prospectus, National Association of Securities Dealers licensing of sales representatives, etc., the SEC regulates sales loads on these policies pursuant to Section 27 of the 1940 Investment Company Act. This section limits the sales load which may be deducted under plans for the purchase of securities on a periodic payment basis (and note that variable life insurance is considered to be a security under the Federal securities laws), and it would present problems for traditional insurance compensation patterns if it were applicable without modification to variable life insurance.

The SEC issued Rule 6e-2 in the 1970's to exempt "traditional" variable life from certain of the sales load limitations under certain conditions. Some of these conditions and assumptions might not be appropriate with a flexible-premium design. For example,

1. On a very basic level, what will the SEC consider to be the premium--the amount paid by the policyholder or the cost of insurance which is deducted from the fund? Also, since a variable universal policy could be a single-payment plan, will the SEC view it as being a periodic-payment plan (with up to a 50% sales load possible in the first year) or a series of individual purchases (with much smaller sales loads permissible)?

2. An acceptable sales load pattern for VLI cannot exceed an average of 9% of premiums over the lesser of 20 years or life expectancy. This part of rule 6e-2 is conditioned on a fixed schedule of premiums and may not be appropriate in the context of unscheduled payments, cessation of payments for one or more years, etc.

Other questions needing resolution concern sales loads obtainable when the amount of insurance and/or the amount of premium is increased by the policyholder, and acceptable levels of rear-end surrender charges.

An industry group is expected to initiate discussion of these issues with the SEC staff in the near future. Variable universal life will remain an idea whose time is yet to come pending resolution of these sales load exemption questions.

MR. DESROCHERS: When the discussion turns to the 818(c) election, the topic on most people's minds is the approximate revaluation under Internal Revenue Code section 818(c)(2). In considering the approach which companies take to the approximate revaluation, it is necessary, I believe, to distinguish between tax reporting and product pricing.

From a tax reporting view, a clear trend is for companies which use the approximate revaluation for other products also to elect it for universal life. Most companies are using a $19.00 whole life allowance, but others are using the $5-per-thousand allowance for term. One approach which has been discussed is to differentiate among universal life policies by the amount of premium in force per thousand, thus basing the treatment on the "theoretical" plan of insurance in force. It also seems clear that most companies are pricing under the assumption that the product will remain profitable even if the approximate revaluation is not allowed.

In analyzing the issue of approximate revaluation, there are two concerns. The first relates to a definition of a reserve basis for universal life. The regulations issued in connection with section 818(c) require the valuation of all reserves to be computed on one of the "recognized" preliminary term bases. Clearly an item of controversy is whether or not universal life reserves meet this standard. Certainly, the work that the American Council of Life Insurance (ACLI) has done will be a significant factor in this area. A related question, which I would like to comment on, is

the need for a preliminary term reserve basis for a back-loaded contract. Many companies introducing these plans would like to set up reserves on a basis which allows the recognition of all or part of the surrender charges. While this is consistent with the philosophy of a preliminary term method, there is very little guidance currently available in this area.

A second issue transcends universal life, and that is the likelihood that the approximate revaluation will continue in any new tax legislation. It is clear that the effect of this provision has attracted the attention of the tax policymakers in the government. It is unclear as to whether or not this will be a feature of any new tax law, and what form it might take. This may be considered an additional argument for the need to develop a true Commissioners Reserve Valuation Method (CRVM) for universal life, particularly if the exact revaluation of the reserves is allowed.

MR. LEFF: Although flexible-premium life insurance is mentioned in the United States income tax code, courtesy of TEFRA (1982), the valuation and nonforfeiture laws effective in the 50 states and the District of Columbia make absolutely no reference to universal or flexible-premium life. The pre-1980 NAIC Model Laws provided for no flexibility as to unscheduled changes in premiums or benefits, while the 1980 Model Laws provide that the insurance commissioner may promulgate regulations governing reserves and cash values when the laws are not directly applicable to a given policy design.

The NAIC is presently considering an ACLI-drafted model guideline, of the type contemplated under the 1980 NAIC amendments, which would specify the methodology and requirements for calculating minimum reserves and nonforfeiture benefits for "adjustable-cash-value" policies--any life insurance policy (not necessarily having flexible premiums) which contractually provides for separately identified interest credits (other than in connection with dividend accumulations, premium deposit funds, or other supplementary accounts) and mortality charges to be made.

With regard to valuation, the current draft of the model guideline defines net level premium and CRVM reserves prospectively. With regard to nonforfeiture, the draft defines a retrospective nonforfeiture standard for flexible-premium policies such as universal life. For scheduled-premium policies, a prospective formula is defined comparable to the formula for "traditional" adjustable life policies. The reason for the difference here was the ease of calculation and the ease of understanding, as well as the fact that most of the universal life policies on the market today have cash values based on a retrospective accumulation.

Under the pre-1980 Laws, most states have taken the position that universal life is an attractive product for the purchaser and, hence, have interpreted their laws liberally to allow companies to issue the product.

One state that concluded that it could not permit universal life to be sold without specific amendment of the insurance law was New York. Representatives of the New York Insurance Department felt that New York law was sufficiently different from that in the other states (with respect to standard provisions, distribution of surplus and excess interest, etc.) that they could not interpret the law liberally enough to approve the

product. Consequently, an industry group working with the New York Insurance Department prepared legislation to amend the law and allow universal life to be sold in New York. Although this legislation was enacted in June of 1982, the Department could not review policy forms for approval until a number of open items had been resolved--principally, required disclosure and treatment of universal life under New York Section 213, which limits agent compensation.

After a number of discussions with the industry representatives, the New York Department released Circular Letter No. 4 on March 16, 1983, specifying the guidelines for approval of universal-life-type policies in New York. There are some differences between New York's requirements and those of most other states--principally in the areas of disclosure, the annual report to policyholders, and compensation. Several companies have already received approval from New York.

MR. DESROCHERS: My comments on premium persistency will be rather short, as I am much interested in what Jim has to share with us. To paraphrase the Society's motto, this seems to be an area in which there are a great deal of "appearances" and "impressions", but very few "facts" or "demonstrations". Most actuaries with whom I have talked believe that the persistency on universal life has been exceptionally good in the first year, but seem to be unable, either through system resource limitations, lack of a good definition, or brevity of time in the marketplace, to measure persistency. This is certainly a subject that will be watched with interest.

There has been some theoretical work done which would suggest that the premium-paying pattern on universal life products will vary with the economic environment to a much greater degree than seen in traditional products. One example of this is an analysis under differing economic conditions as to what proportions of client resources will be allocated to savings and death benefits. Another area investigated was the potential stability or instability of product revenue. I will refer you to a paper entitled, "Equilibrium Conditions of Universal Life Under Extreme Economic Circumstances", in the 1982.1 issue of ARCH. I believe the point to be made here is that we have yet to see what impact the flexibility given to the policyholder in premium payments will have on the actual pattern which emerges.

MR. ROBINSON: Since Sentry has been selling universal life for one year and half a month, we have little experience of value to report on renewal premium persistency. Consequently, I will limit my discussion of this topic to general observations.

Primary reasons for studying premium persistency are, presumably, to measure the profitability of inforce business and to predict future persistency for use in pricing. This assumes that payment persistency assumptions are relied upon in pricing the contract. I suggest that the risk of payment lapsation is substantially uninsurable. Such a risk is totally within the control of the policyholder and may produce financial as well as mortality anti-selection. When the company is crediting a rate of interest higher than that available elsewhere, payment levels will increase. When an insured is ill, payments will decrease in order to maximize the amount at

risk. Both changes will generally be to the advantage of the client and to the disadvantage of the company. To the extent possible, therefore, the universal life contract should be designed to eliminate dependency on payment persistency. If this is done successsfully, then the study of premium payment persistency levels will not be as critical.

The above discussion does not mean that payment persistency is not important, however. Many of the risks associated with payment persistency may not be eliminated effectively. Thus, analysis techniques will be needed. A significant number of obstacles complicate this process. First of all, many contracts incorporate a minimum first-year premium, which may generate a premium pattern at issue which is anticipated to be non-level. Cash value rollovers in the first year should not be expected to repeat in renewal years. Policies which were sold on a "vanishing premium" basis are expected to exhibit a different payment pattern than those sold on other bases. Thus, although a company can measure persistency, the appropriate standard to which this experience should be compared would be very difficult to determine.

The measurement of the persistency itself, however, will also present problems. My company credits premiums as they are received, rather than on the subsequent policy monthaversary. We send bills 15 days prior to the scheduled due date. If a policyholder receives a bill and pays prior to an anniversary due date, the premium will be recorded as received in the prior year. Thus, measuring premium persistency by policy year for annually billed contracts will be very touchy. A better approach may be to measure cumulative payment persistency. This amount, however, is subject to guideline premium limits which must be anticipated.

Sentry has not established a system for routinely reporting renewal payment persistency. First-year persistency measurement is challenging enough. As our computer system develops, I hope to incorporate this feature. The interpretation of the results, however, will be the more difficult task.

MR. LEFF: A decision to introduce a universal life product is a relatively easy one for many companies--for example, stock companies that sell predominantly term insurance. The decision is not so easy for the "large eastern mutual" we all worked for when we took the actuarial exams.

The typical situation in the large mutual company finds a large inforce of permanent insurance policies, with a relatively small proportion of cash values having been borrowed as policy loans. The business is quite mature, especially as to the nature of its underlying investments--relatively long-term assets, most purchased prior to the significant rise in interest rates in the late 1970's and early 1980's. The sales force tends to be predominantly career insurance agents, rather than insurance brokers or stock brokers; this has generally produced a somewhat stronger relationship between the companies and their policyholders. These companies also find themselves at a considerable tax disadvantage relative to stock companies, although the difference was narrowed slightly under TEFRA.

With this as background, the mutual companies have been confronted with a rapid proliferation of universal life products in the marketplace. If it does nothing, a company is vulnerable to replacement by other companies' products. If it introduces universal life, a company risks accelerating greatly the rate of internal replacements.

Do not be misled by some of the problems I just mentioned and think that universal life has no positive attributes for mutual companies. In a volatile, high-interest environment, universal life can be very attractive to both prospect and company--a sort of "buy term and we'll invest the difference" approach. Universal life also satisfactorily addresses the issue of equity between borrowing and non-borrowing policyholders via direct recognition of policy loan activity. Finally, having a universal life product available can be an excellent conservation tool. Surprised? Well, consider the following two agent/policyholder exchanges:

> Policyholder 1--"I'm dropping my whole life policy with your company and replacing it with company x's universal life policy."
>
> Agent 1--"Universal life is not right for you, and I recommend retaining your present policy."
>
> Policyholder 2--"I'm dropping my whole life policy with your company and replacing it with company x's universal life policy."
>
> Agent 2--"Universal life is not right for you, and I recommend retaining your present policy." (Sounds familiar, so far!) "But if universal life is what you really want, I will sell you our company's product."

While many of you may dismiss the foregoing as being idealistic and unrealistic, we have seen actual evidence that it does occur. Not only that, but the outcome frequently is maintaining the whole life coverage, sometimes unborrowed, and buying additional coverage, perhaps through a universal life sale.

In any event, after much deliberation over the pros and cons of universal life, many mutual companies, including Metropolitan, have decided to proceed to develop it. At Metropolitan we decided to sell it through one of our stock subsidiaries. While this gives us the same tax advantages available to pure stock companies, we do encounter some bookkeeping problems when "internal" replacements cross company lines.

We decided to test market our product for three months in Florida--a sunbelt state where we have a relatively strong marketing presence, and where replacement and competitive pressures have been especially strong in the recent past. Also, last but not least, came a very practical reason: Florida was one of the earliest states to approve our policy form.

We hoped to gauge the reaction of our sales force to our product and our rather hard line on internal replacement with regard to agent compensation. We wanted to judge the performance and capability of the software system which we purchased. We wanted to see whether universal life would continue to be a viable product with interest rates of 10% and under, or whether its early success was "proportional" to its early, high interest rates. And finally, we wanted to determine the impact of universal life availability on sales of more traditional permanent insurance products.

While we are just completing our analysis, we find that agent acceptance has been quite favorable, although some feel our commission restrictions on

internal replacements are unduly harsh. We find that less than 10% of our universal life issues involve any policy loan, surrender, or dividend withdrawal activity on other Metropolitan policies in the six-month period preceding issue of the universal life policy or in the one-or-two-month period subsequent to issue. We are seeing whole-life-type premium levels, and over 70% of our universal life issues are on a pre-authorized check mode, boding well for future premium persistency. Finally, as best we can tell, our universal life sales activity does not appear to be reducing sales of other permanent plans; a much higher percentage of our universal life sales are to first-time customers of the Metropolitan than has been our usual experience when introducing a new plan. All in all, we have concluded that our test marketing in Florida has been successful, and we expect to expand within the next few weeks into the other forty states which have thus far approved our policy.

MR. ALBERT K. CHRISTIANS: I am wondering upon whom TEFRA put the onus for seeing that the guidelines are observed. There seem to be three possibilities: first, that the contract provide that the guidelines can never be violated; second, that the company see that they are never violated; and third, that the policyholder be at risk if he violates the guidelines or causes his contract to violate them.

I believe that one of the alternatives specified that compliance had to be by contractual provision, but that the other did not. I would like to give my interpretation of what is a reasonable reaction to that and have the panelists give their criticism.

It appears, not because TEFRA requires it, but just from marketing considerations, that you must contractually provide that the contract will always qualify; that you would have to provide contractually always to increase the coverage so that the ratio of cash value to face amount does not exceed that specified by the guidelines. We would like to make it a contractual provision that once that requirement comes into effect we will not necessarily accept additional premiums under the contract. I guess that is the question: Must contracts specify that they will always comply, or does some of the onus for compliance rest on the policyholder or on company discretion?

MR. DESROCHERS: I think that in considering the application of the TEFRA guideline it is important to recognize that the second of the two tests was not specifically intended for universal life. In the Senate Finance Committee workup of Section 101(f) it was not mentioned, and there was some concern that the TEFRA guideline would be applied to traditional adjustable-life-type contracts. As a result, in the Conference Committee the second test was added. However, there was really very little discussion and very little study of that issue before it went in. I think clearly the onus of compliance is on the company, and I think many companies do incorporate the guidelines in the contract. It is not necessary, but if you do not, the scenario that I see happening is that somehow the contract is violated, somehow the death benefit treatment is denied, and the insurance company is open to a suit in equity for the tax that has to be paid. And I think most companies really do recognize that the administrative onus is on the company.

MR. CHRISTIANS: Do you refuse to accept additional premium if it would violate the guideline? Do you increase the face amount automatically to keep it sufficiently ahead of the cash value?

MR. LEFF: We will automatically increase the death benefit in conjunction with that. Fortunately, by the ages where the anti-selection would get to be most significant we are down to a 5% minimum corridor between the death benefit and the cash value. If we had something like a 40% minimum, the risk might be greater. But I for one would not sell the product without having a provision in there granting the increase in death benefit. The onus is on the company as far as I am concerned.

MR. DESROCHERS: I think that is a pretty common provision. Certainly, the risks are greater under a single-premium type of test, but even in contracts which had a percent-of-cash-value corridor before TEFRA there was often a provision that the company could refuse to accept additional premium.

MR. ROBINSON: When TEFRA was passed, we did consider utilizing the adjustable-life alternative, under which we would have probably built into the contract an increase in death benefit which was the reciprocal of the net single premium times the current cash value. We rejected that primarily because of the anti-selection possibility and also because under the universal life alternative, once the premium has complied, you do not have to worry about what interest rates you credit to that premium. When we chose the universal life alternative, we already had provisions in our contracts that can prevent a policyholder from increasing the scheduled premium or making unscheduled payments. One of the last things we want to do, of course, is turn down premiums. So we will suggest several other changes in the contract in order to alleviate that problem.

As to who the onus is on, I think that as the industry has moved into more investment-oriented products, we have acquired less insurable risks. Things like policy loans, which have been mandated by the states, and cash values have become a more significant part of the sales process. Now, the last thing I think the company wants to do is to take on another uninsurable risk--the tax risk. From a practical standpoint I think that the company has to provide as much information as possible to the policyholder, but when we sell our contracts we make disclaimers indicating that the client should consult a tax adviser.

MR. CHRISTIANS: Would you put in a disclaimer even if the company undertakes to keep the contract in compliance?

MR. ROBINSON: It is to the company's advantage to try to keep the contract in compliance. To try to guarantee that, however, would be very difficult. So we do try to provide as much information as we can to help the policyholder keep the contract in compliance, but it is a difficult issue.

MR. IAN M. CHARLTON: I have two questions. First, would you comment on what the start date for the monthly calculation might be on COD business? Would you charge back to the policy date, or would you work from the premium receipt date? Second, if a policyholder changes from Plan A to Plan B to increase the death benefit, is the guideline premium now based on B, or is it based on a combination plan where the premium and the benefit have changed?

MR. ROBINSON: In essence you are asking when we start crediting interest under the plan. We try to prevent back-dating before the actual delivery of the premium as much as possible. We have procedures installed that keep it to about a two-week maximum. We do start crediting interest as of the

effective date of the policy, whether or not the premium is in our hands at that time. We have told our underwriters not to back-date the policy to save age, because it could bring quite a large windfall to the policyholder. We recognize that problem, but we do start crediting interest as of the effective date.

As for your other question, with regard to when a policyholder changes from option A to B after issue, the formula that I have developed for use at Sentry involves a melding of the two. It would recognize that you had been under option A for the first n years of the policy and would be under option B for the remaining term.

MR. ANDREW F. BODINE: With regard to TEFRA, I think most companies are putting a scheduled death-benefit-minus-cash-value corridor into their products, but they are not including contract provisions for premium limitations. The premium limitations are disclosed more on the ledger-sheet illustrations and in the annual reports to individual policyowners.

With respect to after-issue changes of the premium limitations affected by benefit changes, the people I have talked with are comfortable with how to make those adjustments when benefits are increased. I think there is a big question as to how to handle benefit decreases. When the policyowner decreases benefits, can one of the panelists tell us how the premium limitations--the single premium guideline--would be changed?

Second, with regard to the development of the TEFRA law, my understanding was that the wording regarding annuities was included in order to permit excess cash values, after they reach their maximum, to be rolled over into a deferred annuity rider. The excess values in the annuity rider would get annuity treatment as a death benefit, leaving the balance of the policy to get the favorable Section 101 treatment as a life insurance benefit. Would you comment on whether my understanding is accurate?

MR. DESROCHERS: There is, indeed, a statement in the TEFRA blue book that would lead you to believe that the attachment of an annuity rider to universal life contracts is acceptable. Certainly, it is something which was in the minds of a great many companies, because there seems to be a moral law about returning money to policyholders once it has been paid. There has been, I think, some controversy about whether it is appropriate to attach an annuity rider. Some of the lawyers for the companies that I have dealt with are uncomfortable about qualification if there is an annuity rider, about the form that that annuity rider should take, and about whether you can attach an annuity rider with no money at issue or whether, in fact, you need an application with a current date. I think there are a number of practical drawbacks to the use of an annuity rider.

My own speculation is that the problem is not what the Treasury's position may be, but rather just the mechanics of how things can be handled. Another issue arises from the fact that if you allow the money to stay in the contract and take advantage of the year-end, grace-period-type provisions, you are then allowed to return money. The interest that you credit is, in fact, taxable, and that creates some reporting difficulties if you use an annuity rider. What do you do with that interest? Do you send a Form 1099? Do you send some money back? There are some practical limitations.

To address the other question just quickly, it seems clear that the intent of the drafters regarding adjustments after issue was that you make an attained-age adjustment, perhaps on a before-and-after basis, so you increment the guideline premium. That is certainly what the examples in the blue book do. A real issue is what you do on decreases, because there are situations in which the contract is not fixable. Certain actions of the policyholder may cause the contract by its very nature to be out of compliance. I think that is an area that has been identified, but not adequately addressed.

MR. SHANE A. CHALKE: I would like to follow up on something that Mr. DesRochers mentioned, which was that it has become a rather generally accepted practice, in demonstrating compliance of universal life with the nonforfeiture laws, to point out that your mortality charges do not exceed the valuation mortality rates--currently 1958 CSO rates. This reflects a misconception as to how the laws might apply to these plans. The mortality charge you are deducting is really just part of your rate structure. Any regulation of, or implied constraint on what you can charge for your mortality deduction is a form of rate regulation, which we do not have for any other types of plan. Even under the classical retrospective demonstration, it is quite easy to provide compliance with mortality rates that are greater than valuation rates. As a matter of fact, to have guaranteed rates greater than valuation rates is being on the conservative side. It is much more difficult to prove compliance when your rates are less than valuation rates.

One of our main concerns when we developed the ACLI's proposed guidelines was that we have no constraints on any of the individual components of the plan design. I think we are going to have to work very hard over the next couple of years trying to avoid rate regulation of universal life. We are seeing a lot of attempts at that at the various state levels.

MR. DESROCHERS: I would like to compliment you on your paper. For those of you who do not know it, Mr. Chalke is one of the authors of a paper on universal life reserve requirements that is out in pre-print. It is quite good.

I think the issue here is that we are all living under the shadow of the E. F. Hutton Life demonstration, and that the states are quite comfortable with that kind of demonstration, which does limit the guarantees to the 1958 CSO rates. In product design, particularly in filing, we tend to take the easy way out, and I think that is why many of the demonstrations are done that way. Also, the ACLI work has not been generally adopted by the states; it is still in the discussion stage. But Mr. Chalke's comments really do get to the issue.

MR. ROBINSON: When we developed the actuarial memorandum for our contract, I departed from the norm, and rather than place the nonforfeiture standard in a retrospective context, I translated the cash value accumulation formula on our contract into a prospective formula and then demonstrated compliance entirely in a prospective sense. It becomes clear under that demonstration that the mortality and interest standards in the nonforfeiture law are meant to be minimums, or the reverse of what they are typically interpreted to be as applied to universal life. In other words, you are penalized under this approach for guaranteeing mortality charges that are more liberal

than 1958 CSO, and you are penalized for guaranteeing interest rates that are greater than the nonforfeiture interest rates. So I agree with the comments from the floor.

MR. THOMAS G. KABELE: I wrote a paper on universal life tax issues, and one of the minor issues raised in the paper was what I called the policyholder dividend accumulation problem. As you know, dividend accumulations are currently taxed to policyholders like savings accounts. The company must send 1099's and, under current law, even withhold. Now, in universal life equal amounts of excess interest are added to cash values and death benefits under one option, and under the other option the cash value increases and the death benefit does not. How are we going to resolve this inconsistency? Should we try to change the law so that dividend accumulations are taxed as life insurance reserves, or should we change the law so that it is clearer that universal life companies have a dividend accumulation option and should withhold interest and send 1099's?

MR. DESROCHERS: I wish the issues in the tax code were quite that simple. Obviously, the general nature of what is going to happen in taxation depends on what the perspective of Congress happens to be and what kinds of things the industry can or cannot agree on. If consistency were a part of the tax code, I think many tax lawyers would be out of business.

MR. JOSEPH YAU: I have a comment on the ACLI proposed guideline for the minimum cash value calculation. The proposed guideline appears to discriminate against back-loaded products, as distinguished from front-loaded products. I think that clearly violates the spirit of the Standard Nonforfeiture Law, which is not to discriminate against the way you structure your product.

Also, I have a question on the ACLI proposed minimum reserve requirement. The latest version that is proposed by the ACLI differs significantly from the 1981 preliminary version, and I wonder what the major considerations entering into the changes were.

MR. CASE: One consideration was to recognize that there will, most probably, be further premium payments coming in, and that they should be reflected in some way in the reserve formula. Another consideration was to have a formula that was much closer to the CRVM formula that is in the laws. The earlier version had not been as close. The advantages of this approach, it is hoped, will be better acceptance by the states of these reserves as a solvency standard and better acceptance by the Federal government of the reserves for tax purposes.

MR. YAU: Has any test been done to see whether the first version and the second version generate the same minimum reserve if we apply them to a particular policy?

MR. CASE: I do not recall that such a test has been done.

MR. YAU: My last question is on the ACLI proposed nonforfeiture guideline. If we apply it to a traditional product, does it give the same minimum cash value as is given by the standard nonforfeiture law?

MR. CASE: The ACLI proposal has again changed form, as a result of a meeting of our task force that took place just a week or two ago. For scheduled-premium policies our task force's proposal is now very close to the adjusted-premium formula that is in the law, and I suspect that there is close comparability there. For flexible-premium policies our proposed approach is a retrospective one. Since universal life and traditional life are such different products, I am not sure that the kind of equivalence you are referring to is necessary.

MR. YAU: I believe you should be able to apply the nonforfeiture guideline to a traditional product as a special case and generate the same minimum cash value as you would under the law.

MR. CASE: I believe that the primary concern of our task force was to achieve equity between continuing and terminating policyholders. We had to try to achieve that goal for a policy with flexible premiums, which, of course, can generate many different scenarios.

I want to thank our panelists and the audience for what I found to be a very interesting session.