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FLEXIBLE PREMIUM VARIABLE LIFE

Moderator: JOHN W. KELLER. Panelists: ROBERT B. GOODE, JR., ROBERT L. LINDSAY, PAUL J. MASON. Recorder: WILLIAM W. CARTER*

1. Definition of the product and discussion of possible design variations.

2. Analysis of NAIC model law and status of state adoption process.

3. Status of SEC regulations.

4. Expected administrative challenges.

5. Marketing.

MR. JOHN W. KELLER: We are going to discuss a product this morning that goes by several names. As noted in the program, in addition to flexible premium variable life, it is also called "universal life II (UL II)". Some people have been calling it "universal variable", and some have been calling it "variable universal". I recall a letter to the editor some months ago in one of the trade magazines arguing which of the latter two names is more acceptable. I believe the author argued that traditional whole life, to be precise, is really "fixed benefit whole life". Variable life (VLI), then, is "variable benefit whole life". Similarly, universal life is really "fixed benefit universal life", and the variable version, therefore, must be "variable universal life" - not "universal variable life".

Fortunately, our discussion this morning does not depend on the proper name for the product. Undoubtedly, it will be brought to the marketplace under a multitude of exceedingly clever and original names, just as has its universal life (UL I) predecessor. Rather, we want to look closely at the development of this product - even as it is still in its embryonic stage.

We have a panel of very distinguished experts with us this morning to discuss flexible premium variable life. The first speaker will be Mr. Robert L. Lindsay, Vice President and Principal in the New York office of Tillinghast, Nelson and Warren. Bob will talk about the definition of the product and possible design variations.

Our second speaker is Mr. Paul J. Mason. Before joining Sutherland, Asbill & Brennan in 1981, Paul was Chief Counsel, Securities, for the American Council of Life Insurance (ACLI). Prior to that, he was with

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the Securities and Exchange Commission (SEC), where he held positions in the Division of Corporate Regulation and the Division of Trading and Markets. Paul will cover the regulatory aspects of the product, focusing mainly on the SEC.

Our third panelist will be Mr. Robert B. Goode, Jr., Executive Vice President of The Hartford Life Insurance Companies. His company has been one of the most active in marketing universal life insurance. In connection with flexible premium variable life insurance, Bob helped form the group of companies to spearhead the regulatory changes necessary for the introduction of the product. Bob will speak on the administrative and marketing aspects of flexible premium variable life.

MR. ROBERT L. LINDSAY: It is my contention that flexible premium variable life insurance will become the dominant permanent product sold on an individual-policy basis by the end of the decade. I believe that this will occur due to the increasing education level of the American population and a greater sophistication about investments and financial matters. Also, many companies will realize that this product offers an opportunity to control agents and to obtain significant growth in two key areas - namely, assets under management and insurance risk. These are the two primary sources of profit to life companies - arbitrage on assets and a risk charge on the insurance risk.

History is often a great teacher. Therefore, before contemplating possible designs for a flexible premium VLI product, it might be helpful to briefly review the history of equity-linked products.

The Dutch introduced the first equity-linked life product about 25 years ago. The initial product was fully linked; that is, everything was expressed in units, and unit values were based on the value of an equity-based account. Thus, the face amount, cash values and premiums all varied with the stock market. This product was not widely sold, because purchasers did not like the fluctuations in premiums. With the benefit of hindsight, this sales negative is fairly easy to see. For example, if you owned one of these policies, your premiums would have increased by more than 50% during the past year. However, your net income may not have increased at all.

The Dutch later introduced a level premium version of the product. The underlying investment account was again common stocks. Unfortunately, the market was declining at the time, and the public was bearish on equities. Eventually, VLI virtually disappeared in Holland because the product continued to be linked to equity funds.

The experience in the U.K. has been considerably better. In the 1960's Abbey Life marketed a VLI product which had a level premium and guaranteed death benefit. The cash value was not guaranteed and varied with the performance of a separate account according to a complex formula which was not guaranteed. Sales were modest. International Life came out with a much simpler product which was much clearer to the policyowners, and it sold quite well.

Separate-account-based products have been very well received in the U.K. One of the main reasons is that the insurers have provided their policyholders a choice of accounts. The first separate accounts were common stock based. Real estate accounts were added in the late 1960's. In the early 1970's fixed-income and money market funds were added to achieve sales growth when the common stock market declined. By allowing the customer to make the investment choice, the burden could be transferred to the customer. Thus, the company could not be held responsible for the poor performance of the stock market, and the attractiveness of the product could be maintained.

It is interesting (again looking at the U.K.) to see who marketed the product. The smaller companies initiated linked products while the established companies continued to emphasize traditional products. These upstarts began to erode the market share of the old companies. The latter were forced to introduce similar products. However, they reacted too late. A company like Hambro, which essentially started business in 1972, now has assets of more than $4 billion and a significant premium income. The lesson is a simple one - no company can buck fundamental trends in the marketplace.

South Africa is the other successful market for linked products. Products are similar to those offered in the U.K. The companies provide one additional account - a managed fund. The investment advisor blends real estate, fixed-income investments, common stocks and other investments to achieve the desired investment objectives - a sort of fund of funds.

The experience in the United States with fixed premium VLI products also demonstrates the need to offer more than one investment account. At a minimum, a common stock account and a short-term account would be needed to introduce the product on a competitive basis. A public bond account could be provided if adequate funds and diversification can be obtained.

A real estate account might be popular with potential policyholders; it certainly has been in the group pension business. However, problems arise from the illiquid nature of real estate and the need to value assets to market on a regular basis. Perhaps a simpler way of owning real estate is to purchase shares of companies with significant real estate holdings such as certain REIT's.

A managed account might prove to be a popular alternative for those who are willing to assume some investment risk but wish to emphasize a more stable growth. A managed account could conceivably have a small proportion of its assets invested in a real estate account and yet maintain a sufficient amount of liquidity. One intriguing idea is to provide some minimum cash-out guarantees with a managed account. I have ignored any regulatory problems. In effect, the traditional whole life product is backed by a managed account. The major difference is that the latter does not fully reflect market values.

The investment alternatives and performance may well be the deciding factor in achieving market share in this important product line.

Let's talk a little bit about product design. Outside forces tend to constrain VLI more than many other products. Companies will need to conform to the requirements of the SEC as well as those of the Internal

Revenue Code (IRC). Finally, companies will need to comply with the plethora of state regulations as well. Thus, some of the potential flexibility in product design, both at the company and the individual level, will not be available.

Despite these outside constraints, companies should be able to introduce products which have broad appeal in the marketplace or which are designed to meet specific needs of certain segments of the market. It will be important to more carefully define market segments for this product than for traditional life insurance, because the product must be suitable for the client before it can be sold. This suitability screen is for the policyholder's protection. The net effect may be that most VLI will be sold in the middle-income and up-line markets.

It may be possible to come out with a product for the masses on a payroll-allotment basis. This product would need to be simple and less flexible; and perhaps it should provide some long-term guarantees. The separate account supporting this type of business should probably be a managed account.

The bread-and-butter product is apt to be the universal-life-type product which affords the policyholder flexibility in premium payment and in the amount of insurance at risk, subject to sound underwriting requirements and IRC constraints on the relationship of face amount to cash values (e.g., death benefit at least equal to 250% of cash values at age 40 grading down to 110% at some higher age). The first products to be introduced are apt to be front-end loaded - all sales loads deducted from premiums as received. It is much easier to describe front-end loads to clients and the SEC. Also, this approach may be more sound in that the company recovers its cost immediately.

I'm sure that a back-end-loaded product will also be introduced at some point if all of the regulatory questions can be resolved. There is no question that the public likes no-load products where all of their contributions are applied to the investment accounts. The trend in mutual funds, tax-deferred annuities and universal life products indicates that back-end-loaded products are quite salable.

Some companies are considering a combination level-load and back-end-loaded product. Traditional fixed dollar whole life fits this mold. It is my opinion that flexible premium variable life will be complicated enough; the dual-loaded product will be more difficult for the agent to understand and to explain. Thus, we can expect an increased chance of misrepresentation.

The more obvious product designs include the following:

- Level face amount;
- Level net amount at risk (i.e., face amount plus cash value payable at death);
- Increasing face amount to a certain age, say 65, on either a pre-planned basis (e.g., 5% increase each year) or based on some outside index (e.g., CPI).

All of these designs would have a minimum net amount at risk to meet the IRC corridor requirements for life insurance products.

VLI might be an attractive vehicle for funding qualified pension plan business. A side-fund rider could be used to accumulate excess funds. Thus, the basic VLI policy would conform with the IRC definition of life insurance, and any excess cash values would be accumulated separately.

It may be possible at some point to buy VLI on margin. Let's assume that the policyowner funds VLI with common stocks. Why shouldn't the policyowner be permitted to buy more stock using the amount in his account as collateral? In order to provide some downside protection, a 75% margin might be required for common-stock-backed accounts and a 50% margin for corporate bonds. It may even pay to borrow against short-term accounts because the cost to borrow (after tax) may be less than the return to be obtained. Of course, this assumes that the 4-out-of-7 rules can be satisfied by a flexible premium product.

This is a fascinating product which should broaden the horizons for the life insurance industry and life company actuaries. Let's hope it doesn't become strangled by red tape or the lack of administrative support.

MR. PAUL MASON: It is interesting that things have changed so dramatically that there has been no sense or thrust that flexible premium variable life could escape SEC regulation the way people perceived the first VLI product fourteen years ago. This interesting phenomenon is somewhat relevant to today's discussion, because when VLI was first considered, there was some strong feeling that it would be the product of the 70's. It still is not clear from the history of the past 10 years exactly what has retarded its progress. It could have been the heavy role of SEC regulation. There are people who say that, but for the position the SEC took, the VLI product would have had a greater degree of success. There are others who blame the poor initial market receptivity of VLI on the poor performance of the equity markets at the time (unlike the growth markets of today). It is interesting that just in the past year or so there has been a great resurgence of interest in that product, even before UL I and UL II.

The first company was EVLICO (a subsidiary of Equitable); and on the basis of phenominal sales as reported in the trade press, several other companies came into the market. There are at least six other VLI writers that have cleared the SEC with their registration statements and have been selling for a year to two. There are two to four additional major companies that are interested in the variable life product. So as we talk about universal life and flexible premium variable life today, I want you to keep in mind that there are serious considerations still being given out there. We do speak to people who want something that is more known than unknown, and they want to know the ground rules so that they can get into the business a little bit faster. One should not discard the fixed premium VLI product as one which is past its prime, because the companies selling it have had very good results.

I would like to give you a feel for the characteristics of both UL I and the fixed premium variable life product and to extract what it is that the new flexible premium product represents. Also, I would like to highlight for you what the industry has proposed to the SEC as a regulatory course for UL II.

I will not spend much time on the state issues. In terms of the NAIC rules and regulations changes needed for this product, the work was completed within a year. They now have a regulation in force which each state can pick up and adopt accordingly. The state-by-state adoption has been slower and more arduous. Delaware has just adopted amended regulation of this product, and similar regulation is anticipated by the end of this month (October, 1983) in Kansas and Maine.

I suspect that the impetus will pick up considerably in the next six months. The American Council of Life Insurance trade association is directing a considerable amount of its resources to that activity, and they are hopeful that within the next six to nine months there will be another dozen states. When companies that have been on the sideline - although interested in the product - see the progress at the NAIC level and the SEC level, they will be more inclined to divert their own company resources to assisting the ACLI on a state-by-state basis. I would not necessarily take as a negative the fact that we have only three states to report by the end of October. Clearly, there is action under way in the key states. A lot depends on what the pattern has been with variable life today - whether or not the state had the variable life regulation, whether or not it was amended, whether their regulation was by administrative edict or whether legislative action was necessary, etc. You have to go into each state, analyze what the history has been and then try to transpose it into something meaningful in the context of the new product.

Let me discuss the principal differences between fixed premium and flexible premium variable life. Let me give you an overview and then take you back through. The principal differences are fairly obvious. The new product provides for a flexible premium rather than a fixed premium. It provides for flexible benefits. The guaranteed minimum death benefit is not mandatory, and there are different consequences of investment experience.

The effort on the part of the industry was to make a submission to the SEC which would draw upon the SEC's experience with individual companies (the six or eight that I referred to) and build as much as possible on the existing Rule 6e-2. Accordingly, the ACLI filed a petition with the SEC on June 29, 1983 (copies were sent out by way of General Bulletin to ACLI member companies). Additional work was necessary, and consequently a supplemental petition was filed on September 15, 1983. The supplemental petition, which is a necessity for anyone doing serious work in this area, is now being sent to all member companies. I suggest you look at the two bulletins; and if you have trouble, someone at the ACLI should be of assistance.

The industry proposal assumes that the flexible premium VLI is a security and that the separate account is an investment company. The fixed premium VLI controversy of a dozen years ago over the SEC jurisdiction is clearly not being repeated in this context.

The proposal is premised on the belief that flexible premium VLI is generally entitled to exemptive relief on terms similar to Rule 6e-2. We are hoping that this will be called Rule 6e-3 so we will have, in sequence, a 6e-2 and 6e-3. Conventional life insurance will work under Rule 6e-2, and this product will use the 6e-3 Rule. The justification for the Rule 6e-3 would be similar - that is, the incompatibility of the 1940 Act and life insurance, extensive state regulation which exists in this area, and the unique nature of the product. Anyway, the petition does conclude that the new rule is necessary.

The proposal is a very lengthy submission - the two documents together are over 200 pages. Probably 50 pages are the rule, the other 150 are the detailed explanation, background and summary. Hopefully, the proposal is as intelligible as possible - it is probably much more comprehensible to the actuary than to the lawyer. We find the communication to be much more effective with an actuary who has had some exposure to variable life than with a lawyer who has experience in general equities but not in variable life.

With respect to the product itself, there are certain characteristics which are clearly the same as fixed premium variable life. Cash values and, indirectly, death benefits will reflect the investment experience of one or more separate investment accounts. The new product will provide significant current insurance protection with an immediate death benefit of perhaps many times the amount of the initial premium. It will provide for other conventional policy rights and privileges.

Now let's move over to universal life. I ought to point out that the SEC has not yet determined that universal life, as we know it, need not be registered with the SEC. Over a year ago they sent a letter of inquiry to some fifteen companies that they identified as selling the product. They were inquiring as to why the companies had not registered the product and were questioning under what legislative or statutory authority they had chosen not to register. That inquiry, which was of considerable interest a year ago, seems to be somewhat dormant. My own personal view is that the overburdened SEC staff took the position that perhaps the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) would have a negative impact on the product (although they were not wishing for it) and that, therefore, the matter did not deserve particular attention. However, TEFRA and the new legislation have proved otherwise; and now the SEC staff is keenly interested in both the universal life products.

What are the characteristics of universal life which are preserved in the new product? First, the amount and the frequency of premium payments generally will be flexible and determined by the policyholder. Target premiums, payable periodically, may be stipulated; but policy lapsation will be keyed to insufficient cash values, so that failure to pay a target premium will not of itself cause a policy to lapse. With respect to the death benefit structure, many designs will be possible, including some very similar to those currently found in fixed premium variable life. The typical characteristics would include the following:

- The policyholder will be able to elect one of two death benefit options similar to the level-death-benefit and level-net-amount-at-risk options contained in existing universal life policies.

Secondly, consistent with the ability to vary premium payments and to adjust the face amount, a guaranteed minimum death benefit will not be inherent in most policies, except to the extent that a death benefit is payable to the end of the grace period. Policyholders typically will be allowed to adjust the face amount of insurance independently. Decreases will be subject to a prescribed minimum face amount. Increases will be permitted subject only to evidence of current insurability.

I believe that a broad variety of charge structures will develop. Sales and administrative charges will include front-end charges deducted from the premium, back-end loads which may or may not be contingent upon surrender or withdrawal, and periodic charges against the cash value. You'll see charges which may be computed as a percentage of premiums, a fixed dollar amount, a dollar amount based on the face amount of insurance, or a percentage of cash value.

What issues will the industry have to face to bring this product under the 1940 act? Since the industry has assumed that this new product would be treated as a security subject to the Act, the whole framework of the past year was to develop the rule accordingly. The separate account is the key to all of this. The proposed rule would allow both fixed premium and flexible premium variable life insurance to be funded in the same separate account.

Several policy-design requirements are reflected or demonstrated in the rule. First of all, consistent with the policyholder's ability to adjust premium payments and the face amount of insurance, the proposed rule does not require a guaranteed minimum death benefit of a specified amount. Secondly, the assumption of mortality and expense risks by the insurance company is required, but no maximum amount for a risk charge is specified.

The heart of the entire proposal deals with the sales load. The most troublesome aspect of the 1940 Act for the industry was to try to bring together a meeting of minds which would encompass what is traditionally considered a sales load in the SEC arena and what is considered compensation, commissions and sales load in the traditional life insurance arena. This has been the pattern for the past 15 or 20 years with whatever product the industry has developed, whether it is the variable annuity, variable life insurance or anything else in the equity area that requires SEC registration. That is the accommodation which has always been the testiest, and that's the accommodation which was most important to accomplish this time around.

Let me make some general observations with respect to the sales-load exemptions that are pervasive in the new proposed rule. First of all, the industry proposal seeks substantive exemptions from the sales-load limitations of the Act, generally equivalent to that accorded fixed premium variable life under Rule 6e-2, but modified to reflect the flexible nature of the product. The sales-load relief in 6e-2 is framed in terms of percentages of premiums. Because scheduled premiums are fixed by the insurer and there is a tabular relationship between premiums and benefits, a relief structured in this manner permits companies to structure premiums and sales loads so that a front-end load, declining over time and applied to fixed, predetermined payments, will provide revenues sufficient to cover distribution expenses. The exemptive relief for flexible premium variable life insurance contained in the industry proposal is as follows:

- The exemptive relief recognizes that where premiums are flexible and where there is no fixed, tabular relationship between premiums and benefits, sales efforts and expenses depend on the level of insurance benefits provided as well as the amount of premiums paid. Because of the fixed premium nature of variable life, this was implicitly recognized in Rule 6e-2. The exemptive relief now proposes tests that will allow prospective demonstrations of compliance regardless of actual premium payment patterns; and because relief is based upon certain objective factors set forth in the rule, it will allow for sales-load designs that reduce the opportunity for unfair manipulation of policyholders.

- The relief also provides a dollar amount of sales load equal to or even less than the amount permitted under Rule 6e-2 for an equivalent fixed premium variable life policy. Let's look specifically at the structure of the sales-load exemption. The proposed rule first sets forth exemptions for policies which have only front-end sales charges and are assumed to involve no adjustments in insurance benefits. These exemptions apply the appropriate 1940 Act limitations to a so-called guideline annual premium that is specified in the proposed rule.

- For policies with all or part of the sales load deducted on a basis other than as a front-end load, the exemptions are framed in terms of a so-called economic-value test which indirectly applies the exemptions provided for front-end-loaded policies. The proposal allows companies to receive additional sales loads upon adjustments in insurance benefits, provided that the policy satisfies both an economic-value test and cumulative-sales-load tests. All of this is covered in the very detailed explanation of the petition and also in the specific language in the rule.

Let's look at the guideline premium, which has some history in TEFRA. The proposed rule defines "guideline annual premium" as the level annual premium payable to the highest attained age which a premium may be paid under a policy that would provide the future benefits under the policy, based on certain specified assumptions. These assumptions include a 4% assumed interest rate, 1958 CSO mortality, and the expenses specified in the policy. The "guideline single premium" is defined as the single amount payable at a specified time which would provide the future benefits until the maturity date specified in the proposed rule and which is otherwise computed on the same basis as the guideline annual premium.

Let us also look at applications to sales loads other than front-end loads, because that clearly is a pattern that will develop as well. The proposed exemptions for front-end-loaded policies are indirectly applied to policies with other than front-end sales loads. Specifically, exemptions from the sales-load limitations of the Act are provided, if at all durations (through maturity) the cash surrender value, death benefit and any endowment benefits for the policy are equal to or greater than the values for a hypothetical policy which is identical in all respects to the actual policy, except that it charges only a front-end sales load in any manner satisfying the test in the proposed rule. The proposed rule provides that these determinations are to be made under the following specified assumptions:

1. Payments of the guideline annual premium and the guideline single premium at issue must both be tested in the alternative;

2. Withdrawals or surrenders are assumed not to occur prior to the duration being tested;

3. The net annual rate of return is 4%.

There are additional exemptions for additional sales loads which I will not explain, but I will briefly refer to the economic-value test. The economic-value test corresponds to the test for sales loads other than front-end loads. It provides that the values for an actual policy with an increase may not, under specified actuarial assumptions, be less than the aggregate values for a base test policy (that is, an actual policy without the increase or addition) and an incremental test policy (which would be a hypothetical policy issued at the time of the increase which provides only the incremental change in the insurance benefits), each including sales loads permitted by the 1940 Act. The cumulative-sales-load test is satisfied if, during each policy period through maturity, the cumulative sales load charged to date under the actual policy does not exceed the sum of the cumulative sales loads under the base and incremental test policies.

This was quite a petition (and amended petition) to throw at the SEC, considering that, unfortunately, the SEC does not have an actuary on its staff. When we were dealing with variable life insurance, they did have someone. This time there had to be a great deal of care, duty, attention, conscience, etc., so that one would never be embarrassed or uncomfortable with an industry presentation which is so heavily actuarially oriented.

Let's talk briefly about timing. The SEC has had the original petition for several months and the amendment for only several weeks. The initial reaction on the part of the staff has been favorable. They recognize the need for a high degree of trust and care. They realize that they are not in a position to do the intensive actuarial review that they may ultimately be called upon to perform, so there is a risk there. Hopefully, for everything that is presented, every "i" has been dotted, every "t" has been crossed, and the comfort zone is a secure one.

The staff is in the process of completing a memorandum to go to the full Commission (this is traditional SEC procedure). That memorandum will draw upon the experience of variable life and universal life and will require an additional footnote as to why they made this inquiry a year ago and have not yet followed up. They will then have to discuss the product, making clear that this appears to be a [illegible]ted industry presentation by the trade association on behalf of the entire industry. I don't want to be pinned down on it, but my impression is that the memorandum will go to the Commission in the next six weeks. It then goes on a Commission calendar. It most likely will be discussed at a public meeting of the five commissioners. The recommendation from the staff was that the SEC publish the industry proposal for public comment.

They will not necessarily be putting their imprimatur on it saying that the Commission and its staff fully endorse and support any and all aspects of the proposal; but nevertheless, they will say that this is a new product needing special care and attention and that the Commission ought to put it out for comments. The normal comment period would be about 60 days, but this one could be longer.

The staff has indicated that they would like to have something out for public comment by year end. A comment period of about 60 days or longer would take you into February or March. Assuming no extensive critiques and criticisms, and assuming no extensive criticism from another side of the investment community (such as the mutual fund industry) with respect to the relief being requested, and assuming no request for a hearing, it is conceivable that the Commission staff could digest and review all of the comments in the February/March time frame and send a recommendation to the Commission in April. The Commission would need some time to decide on the fine points of the rule, but it is clear that there is a shot for a rule in place by June. It could be a month later or earlier, and it wouldn't be shocking if it were sometime in late summer.

What is happening in the interim? It is our understanding that a number of companies are looking at products. They are considering continuing with the variable life design as we know it, they are persisting with their current universal life products, and they are considering products which would meet the guidelines of the 6e-3 Rule. A number of companies (less than a dozen) are seriously interested in filing a registration statement before the Commission finally adopts its rule. I am only talking about companies that at the moment are adhering very strictly to the proposed Rule 6e-3. A registration statement filed in that connection has to be accompanied by a major application for exemption. The staff has to look at the two major documents - the registration statement itself (which for all practical purposes is the prospectus and the appropriate disclosure) and the substantive accompanying document that tells the SEC and the world why you need special relief pursuant to the Rule. This is a difficult document to draft and to file - double barreled if you will.

The staff has not made up its mind whether or not it would review or process any filing that came in prior to the adoption of the Rule Apparently, there is some sentiment that if registration statements do come in with the appropriate applications, they would feel obligated to review them. It would indeed be a long shot to try to make something effective before the adoption of the Rule. It would probably be with the understanding on the part of the company that if the Rule were more exacting or arduous in any given respect, the company would then be required to make the necessary modifications pursuant to the amended Rule.

On October 7, 1983, the first registration statement was filed on behalf of a company, but without the accompanying application. The staff now has before it a registration statement and a draft prospectus which is totally consistent with the 6e-3 Rule. I do not know whether or not they will review, process and make it effective before the adoption of the Rule.

That, basically, is where we are on the substance and the timing. You have to appreciate that this is a very volatile period. The Commission has taken somewhat of a back seat on SEC products the past year or so as far as implementing a statement of policy which spells out which products now have to register. They did not go after a number of products; but now they are rather keenly involved in the problem with single premium deferred annuities, because so much attention has been paid at both the federal and state level as a result of the Baldwin-United situation. They now have a new eye out for products which may or may not have to register, but I cannot predict what consequences that will have for universal life.

MR. ROBERT B. GOODE, JR.: My remarks will cover the administrative challenges and marketing aspects of the new flexible premium variable life insurance product. Hereafter, I will refer to the product as UL II.

I want to make a couple of references to the group of companies that were formed to get this product going. Our company, and a few others, decided two years ago that we liked what we saw in UL I and wanted to make that very simple change to UL II. It seemed easy - you just place the cash value into some kind of separate account instead of keeping it in the general account of the company. However, it soon became too complicated for our company to undertake alone. I am sure other companies came to the same conclusion at about the same time.

The ACLI was sympathetic to our cause. However, because we were anxious to get this going on a fast track, we and some other companies talking with Paul Mason and his firm thought that the fastest approach was for us to develop a suggested set of revisions to the SEC variable life insurance regulations - to do that for and with the ACLI. Twenty-nine companies banded together. If there was any common bond, it was that the majority of them happened to be clients of the same law firm; but there were other companies that joined with us. We joined together primarily just to split up a very sizable legal bill.

I think it's important that this was not done outside of the ACLI. It was not done in competition with the ACLI. Rather, it was done in lock-step with them. We talked to the ACLI before we started and have kept them fully informed throughout the proceedings. We turned over to the ACLI our suggested revisions of the model bill and our suggested revisions of the SEC regulations that Paul outlined. We then went through the regular committees of the ACLI and became part of their legislative and regulatory activity. That was not undertaken by the companies.

I also want to say, without being too commercial, that we did turn a great deal of responsibility for the development activity over to the law firm - Paul and his associates. They chaired the committee meetings, called the committee meetings, and really ramrodded the project. I think it was a very fine piece of work that the industry and the ACLI can very much appreciate.

ADMINISTRATIVE CHALLENGES OF UL II

Anyone who has begun consideration of the introduction of UL II has recognized that the administrative process will be most demanding. Whereas the traditional product-development cycle involved product design, followed by an administrative-system design to accommodate the product, I submit that for UL II it will be necessary to design both the product and the administrative systems concurrently and that there will be compromises in each. It is necessary to make design compromises to make the product administerable. It is my understanding that the pioneers of fixed premium VLI would tell us that a similar process was followed in bringing that product to market.

Those companies accustomed to the processing of variable annuities will have an advantage over other companies. Companies in both the universal life and variable annuity lines will be able to utilize their experience in both products to their advantage.

Before turning to the specifics, there are a couple of other points. It goes without saying that manual processing is simply not feasible for UL II. The question is whether to modify existing systems, to build new ones, to purchase a package, or to do some combination of these. The software houses are closely following the UL II developments, and packages are being offered. The second point relates to scheduling the introduction. The critical path to launch date may well be administration, and we should plan accordingly. Do not commit yourself for this product until you are absolutely certain that it can be administered. It cannot be handled out of a shoe box by any stretch of the imagination.

Now I will address some of the specific challenges for the administration of UL II. The unique aspect of UL I and UL II from the administrative side is that no premium payment is necessary to keep the policy in force. That is a marked departure from fixed premium plans, both traditional and variable, where so many administrative activities are triggered by the fixed premium payments. The further departure inherent in UL II is that the client may make each scheduled premium payment and still not have adequate equity in the policy to continue the insurance in force. These characteristics are at the heart of UL II processing.

I would like to cite certain of the unique administrative features of UL II.

- Insufficient Equity - As I mentioned, the possibility of insufficient equity to carry the cost of insurance and other charges will give rise to some design compromises, complex procedures, and important policyholder communications. The model state regulation requires notice of insufficient equity to carry the policy to the next processing date. As an example, consider the case in which the policyholder is told that $X will be adequate to carry the policy for the next year; and then, through market losses, additional payments are needed. How do we explain that clearly? Who is going to do that? Think of the level of expertise necessary to make those very important policyholder communications.

- Reversals and Reconstruction (Undo - Redo) - By this I mean the reprocessing of a transaction. One of the most frequent will be bounced checks. With the normal delay in reporting insufficient funds, much processing will have been done. It is more than just the change in cash value due to unit-value fluctuation. Deduction of cost of insurance and other charges may have taken place. Other occurrences requiring undo-redo are late reporting of death, free-look refunds, and other processing delays. I understand that some software vendors have estimated that as much as half their system design will be to accomplish undo-redo. Again, how do we explain it to the customer?

- Confirmations - It is not yet clear what will trigger a confirmation. Hopefully, annual or quarterly summary confirmations will suffice, supplemented by confirmation of transfers between funds, withdrawals, loans, and death benefit payments.

- Policyholder Communications - The model regulation prescribes certain reports to policyholders, and I would not list those here. A most important point on communication is the level of expertise necessary to explain changes in cash value to the customer. There will be many complex explanations needed, and we must begin early to train ourselves and our people in good, effective communication.

MARKETING OF UL II

In order to analyze the marketing of flexible premium variable life, I have prepared an exhibit of product/marketing factors (Exhibit 1). Let me emphasize that it is made up of both facts and impressions - facts for existing products and some predictions for marketing of UL II.

From the product design point of view, the most important marketing considerations are loading for expense, risk and profit. The flexible premium plans (UL I and II) depart from the traditional load patterns through the introduction of back loads (contingent deferred sales charges). On the determination of loading, the SEC-regulated variable life products have regulatory constraints on loadings; whereas, traditional products have minimal regulatory constraints, and competition is the most important factor in determining loads. Whereas the amount of administrative loading is expected to be comparable or higher for all non-traditional products, the sales loading will be lower for UL I and the SEC-regulated products.

How are the sales loads determined? In the case of fixed premium VLI, it is Rule 6e-2. For UL II, this very important matter is currently under discussion with the SEC, as Paul mentioned. We must have a way to determine at issue that the sales load conforms. Finally, it should be pointed out that loadings and other charges must be disclosed in detail for SEC-regulated products through the prospectus.

COMPARISON OF MARKETING CHARACTERISTICS

	Traditional Permanent Products	Current Form of Universal Life (UL I)	Scheduled Premium Variable Life	Flexible Premium Variable Life (UL II)
Loadings				
Pattern	Front	Front/Back	Front	Front/Back
How Determined:				
Sales	Competition	Competition	SEC Rule 6e-2	SEC - New Rule
Administration	Actual	Actual	Reasonable to SEC	Reasonable to SEC
Amount:				
Sales	--	Less than Traditional	Less than Traditional	Similar to Fixed U.L.
Administration	--	Similar to Traditional	Same or more than Traditional	More than Traditional
Disclosure	No	Partial	Yes	Yes
Sales Compensation	--	50-100% of Traditional	75-100% of Traditional	50-100% of Traditional
Agents' Qualifications	State	State	State/NASD	State/NASD
Proposals	Not Necessary	Necessary	With Prospectus	With Prospectus
Suitability Test	No	No	Yes	Yes
Underwriting	Normal	Normal	Normal	Normal
Policy Loans	Normal	Yes- With Adjustment	Limited to 75-90% C.V.-Gen'l Acct.	Limited to 75-100% of C.V.-Gen'l Acct.
Investment Options	None	None	Family of Funds	Family of Funds
Special Markets:				
Qualified Plans	Yes	Yes	Yes	Yes
Mass Merchandising	Yes	Yes	Limited	Probably
Distribution Systems:				
Career Agents	Yes	Yes	Yes	Yes
P/C Agents	Yes	Yes	No	Maybe
Independents	Yes	Yes	Yes	Yes
Securities Dealers	Yes	Yes	Yes	Yes

Sales compensation levels per dollar of premium will be lower than for traditional products for each of the new plans. The more recent forms of universal life have sales compensation similar to traditional plans through the introduction of commissions based on target premiums. For fixed premium variable life, commissions are the same as traditional or slightly lower. For both variable life and UL II, the regulatory limit on sales load and the 24-month refund provision will act to depress sales compensation.

As indicated, sales representatives will need to be NASD qualified.

There are some interesting differences in the types of proposals required. Tailor-made proposals are a necessity for UL I, and they will be necessary for UL II as well. For variable life forms much information is required in the prospectus, and illustrations must follow prescribed rules.

The state model regulation requires that the insurer establish standards of suitability for both variable life forms, so that some financial information must be obtained from the applicant. Underwriting practices should be similar for all four products.

Policy loans are an important marketing characteristic for many agents. I think you're familiar with the way policy loans work on VLI and UL I. We expect the model regulation to include provisions for policy loans which are very similar to the policy loan provisions on regular variable life.

Investment options for the early forms of UL II should be similar to those in the present form of variable life. The products I have reviewed offer three to five funds or separate accounts for the accumulation account. Later versions may include some form of real estate participation. Another very promising possibility is the so-called managed fund, where the allocation of the customer's assets between the various investment alternatives is made by the company rather than the customer.

All products will be available for qualified plans. Direct mail, employer-sponsored plans, and association programs will all be tried. My understanding is that current variable life has had little application in mass markets, and that may prove true for UL II as well.

Finally, I have listed four broad categories of distribution systems. I predict that all products will be distributed by each of the systems with the exception of independent property and casualty agents. In their case, the NASD qualification may be a problem for the smaller agencies.

In conclusion, I happen to think UL II will be one of the most important products in the future of the life insurance industry. I am a real enthusiast on this product. From a marketing standpoint we actuaries tend to view UL II as a totally new product, when in fact it is largely a combination of current products that is today being held back by regulatory and perhaps administrative constraints. Although complicated from an actuarial point of view, the sales person and the consumer (the more critical parties to the transaction) can readily understand it. I predict that UL II will be a great success.

MR. WALTER MILLER: Regarding product design, the fixed premium variable life policies that have been sold in the United States operate by translating excess investment performance (above a predetermined bench mark) into an insurance benefit - whole life additions in the case of the policy described in our paper or paid-up additions in the case of the so-called Equitable-design VLI policy, which has become the dominant design for that type of policy. The simplest version of flexible premium variable life operates very much like today's universal life policies, except that the cash value is invested in one or perhaps several underlying separate accounts. Under that policy design, excess investment performance is implicitly translated not into an insurance benefit, but into cash, subject only to corridor requirements. What you have, then, is a considerably more investment-oriented product in terms of basic design than the fixed premium VLI. I do not offer that as a disadvantage of this new product, but I think it is something interesting to keep in mind when designing this type of product for your own company.

My second point has to do with taxation. I hope everyone here is aware that the tax bill being developed in Congress (as it stands now) is going to make it somewhere between difficult and impossible to sell VLI on a non-qualified basis. In a nut shell the tax treatment is similar to the current treatment of a non-qualified variable annuity. If the underlying separate account is long-term-capital-gains oriented, as in a common stock account, the SEC will probably require a reserve against unrealized capital gains, following the variable annuity example. This means that 28% of the appreciation in the account cannot be directly translated into benefit increases on the upside, and the policyholder is still going to be on the hook for a tax at ordinary income rates on surrender. If the policyowner dies, the effect is that the 28% hold-back on the build-up of the death benefit is gone forever.

Right now, it's a very unfortunate scenario; and I hope that those of you who are with companies interested in selling variable life in the non-qualified markets, where there is a huge opportunity to market both fixed premium and flexible premium forms of the product, will be active in telling Senator Dole, his staff and his confederates in the Senate Finance Committee about this serious problem that exists right now.

MR. GOODE: I agree with Walter on most things. His observations are all accurate, although I don't believe that UL II is going to be materially more investment oriented than current universal life. Investment performance will be very important in marketing the product, but I do not expect to see large amounts of money dumped into UL II products, any more than we've seen in UL I - if for no other reason than that the IRS is simply not going to allow it because of the so-called definition of life insurance in the current version of the tax bill. I think the universal life writers today are finding that the typical premiums for UL I are just like whole life premiums or perhaps a little less. Unlike the impressions of some uninformed Congresspersons, it is not very investment oriented.

I think this matter of taxation is important in a couple of areas. Walter has mentioned what is often called a double taxation of capital gains in non-qualified variable annuities and universal life. I think he is absolutely right - that our lobbying needs to be more intense. We did not get a correction of that flaw in the Stark-Moore bill, and it is necessary that that flaw be corrected. It is going to require a lobbying effort from here on out by the industry. It is one of the very few issues on which the stocks and mutuals agree, and we should get together and fix it.

The other area is the taxation of policyholders, the so-called definition-of-life-insurance issue. I think the bill as it stands today creates a tax environment that is favorable to UL II and should not deter its progress. The main thing we want to watch out for is that nothing happens to that bill as it passes from the House to the Senate.

MR. BRIAN E. FORMAN: In the current universal life products, we all seem to have loads which we disclose and mortality charges which we do not disclose in the policies. There is usually an implicit profit in there, although not definitely defined. All the policyholder sees in the policy is the maximum charges. If we had that same type of implicit profit loading in the UL II product, would the SEC prescribe disclosure requirements on that issue? Do we have a disclosure problem?

MR. MASON: I am not sure there is anything in that disclosure that is dramatically different from the disclosure required in the past year with respect to comparable annuity products. There has generally been a tightening up with respect to more and more disclosure on charges and expenses, and I suspect you have a pattern developing. I am not sure what you are comparing it with. If you are suggesting that there is likely to be more disclosure on UL II than variable life, I do not think that is going to happen. I think there will be a great effort to draw a comparison between the two.

MR. FORMAN: How about UL II vs. UL I, where we do not have that disclosure?

MR. MASON: That is the most sensitive, because obviously the UL I is not registered. I hope that dialogue does not take place. That could lead us down a path that would be unfortunate, because the SEC could use that as a reason to require registration for UL I. I think the thrust should be to do something comparable to the variable life side and to divert attention away from the disclosure or lack of disclosure on UL I. I am not sure we have enough of a pattern yet to totally answer that question.

MR. JAMES J. KNUTSON: In the last year, I have seen a movement toward lower and lower front-end loads and more toward back-end loads in UL I. I wonder if the present petition includes more companies or enough relief that we can see more back-end-load products available that would pay the same compensation we are seeing in universal life.

MR. MASON: That is a good question which was not sufficiently addressed in my remarks. One of the items that delayed the filing of the petition, and then the amended petition, was concentration on the need to handle the kind of loads to which you are referring. Hopefully, the proposal gives you that same degree of freedom on the low load, no load and back-end load. There was an attempt not to prejudice the development of the product in any one direction. That area became so sensitive, because there seemed to be so many companies disposed along those lines. As Mr.

Goode indicated, we had been working on this about a year when we found it necessary to hire an outside actuarial consulting firm to develop what would be most appropriate, because the legal resources just dried up when it came to that particular problem area.

So, hopefully, that has been accomplished.

MR. STEVE P. COOPERSTEIN: With regard to marketing, what evidence is there that this product will work? I understand why universal life is new and exciting and why the agents took that to heart and went out with it. I understand to some extent why variable life in some areas has done well with 12% illustrations. However, I do not see it that clearly with UL II, even though it's a wonderful product and everything else, and you can say the combination has to be good. For instance, the stockbrokers have not been selling universal life to any great extent, and yet Mr. Goode says the stockbrokers will sell UL II. As for career agents, I do not know if they will understand it - certainly not a year from now, and I am not sure how many years from now. I think we should give real consideration as to where there is a market for this product. Have there been any market tests?

MR. GOODE: I guess that was directed primarily to me and my enthusiasm. As an industry, we really are lousy market testers. I cannot go back and cite a nice clean example of a successful market test by the life insurance industry, the way Proctor and Gamble would, to determine if there is a market out there. If universal life (which was introduced without much market testing) were floundering, I would be somewhat nervous about taking the next step to UL II. In the eyes of the customer and agent, the transition is much smaller than we think it is; and that is the basis on which I think the market will readily accept the product. With respect to stockbrokers, I have indicated on my chart that they do sell some traditional forms; and I would agree with you that the amounts have been relatively small and that the underwriting process will always be difficult for stockbrokers to handle. Continuing efforts are going to be made, and the objectives of some of the major brokerage houses in selling life insurance products is such that they will find a way. I am very optimistic about them when it comes to the UL II product.

MR. MASON: From conversations I've had with marketing people at some of the brokerage firms familiar with the product, UL II is more attractive to them than some of the existing products because (maybe this gets back to Mr. Miller's point on the investment orientation) there seems to be some real appeal for the flexible versus the fixed premium, as witnessed by the success of universal life. When coupled with the opportunity for a stockbroker to allow a customer to choose a stock, bond or composite-fund concept or the discretionary-fund concept that Mr. Lindsay referred to, it seems to be more appealing to his lifestyle. Therefore, the product is not as alien to him as some of the traditional life insurance or fixed annuity products that exist currently.

MR. STEVEN L. WHITE: If a company wants to come out with a product that will be sold as single premium VLI, would it be easier to comply with the regulations in the form of a single premium policy or a flexible premium policy where the person is told just to make a single payment?

MR. MASON: There is a single premium VLI product that is being sold today. It is not a universal life product and not a flexible premium VLI. There is at least one that has been declared effective by the SEC and, oddly enough, being marketed by a brokerage firm. You can, within the existing VLI structure, do a single premium. It is hard to assess whether that's more attractive for your company than some others.

MR. KELLER: I think that under the new regulation there would be no question that single premium would be acceptable.

MR. JACK A. MARSHALL: What do you see as the real advantage to the company of flexible variable life over the traditional variable life?

MR. GOODE: From the company's point of view, perhaps the flexible form isn't any better, except that the consumer and agent will accept it more readily than fixed premium VLI. Based on our success with UL I, we are interested in selling UL II because we think we can sell more of the flexible premium than the fixed premium. If you think UL I sells only because of the high rates of interest quoted in the proposals, then you can't see any advantage to it. I happen to be on the other side and believe that UL I will be a success whether or not the interest rates quoted are exceedingly high, because of the other advantages the customer has in the flexibility of premium payments. I believe my company would offer it because we can sell more of it than the fixed premium form; but the jury is still out, of course.

MR. MASON: There was a conscious and constant attempt to develop a rule that would provide no competitive advantage for the UL II product over the current VLI product. I suspect that in talking to different people, you may find that companies with very successful VLI experience may have less interest in a new product than a company that has not had VLI and maybe not even UL I. You might also find companies willing to make a quantum leap from having no SEC-registered products right into UL II (although that would have been unheard of a few years ago). You also see some companies having great success with UL I that do not want the tremendous regulatory burden of the SEC (qualifications of sales people, etc.). I am not sure that any of us can actually assess the advantages and disadvantages of the two VLI products.

MR. LINDSAY: The future of this product will depend more on the trends of the marketplace than on what immediately benefits the company. The experience in both the U.K. and the U.S. is a good illustration of the trend from permanent fixed dollar whole life insurance to universal life products - you cannot stop what is happening in the marketplace. If people like products with an investment element, the fact that you may be giving up a product with higher, more reliable margins does not really matter. You have no choice but to respond to the market.