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VARIABLE UNIVERSAL LIFE

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- Security and Exchange Commission and state requirements
- Design/development considerations
- Suitable markets
- Administration

MR. DALE HAGSTROM: Today we are going to concentrate on the four or five areas of flexible premium Variable Life Insurance that differ from Universal Life Insurance.

The first area is state regulation. As you probably know, there was an NAIC model regulation adopted in December of 1982. Our first panelist, Steve Roth, is going to tell us where that regulation has been adopted by various states. The second area of specific difference is all of the Securities Exchange Commission rules for a variable product. You have to register the contract, you have to register your separate accounts, and you have to register your agents. These are actions you do not have to do for Universal Life insurance. Steve Roth will tell us about those areas as well. The third area that we may touch on a little later is taxation. Two more important areas are product design and administration. Stuart Grodanz will talk about product design, and Don Paquette will talk about the special problems with administering variable products.

Steve Roth is a partner at Sutherland, Asbill & Brennen in Washington, D.C. He specializes in corporate and SEC areas, and he is an expert on the SEC regulation of insurance products and insurance companies. Steve is deeply involved in VLI (Variable Life Insurance) and instrumental in the development and submission of the industry proposals to the SEC regarding the marketing of flexible premium VLI. The second panelist is Stuart Grodanz, who began his actuarial career in 1971 at Penn Mutual and worked on VLI research and development in 1973 and 1974. He has been at Travelers since 1976 and recently has moved into the individual life insurance product development area where he is involved with pricing, implementation, and developing actuarial factors. Currently he is working on their Variable Life Insurance filing at the SEC.

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The final panelist, Mr. Don Paquette is from PALLM. Don has a background as an actuarial student and for the last ten years has been working on the data processing side. In particular he worked with the group at PALLM that developed a Variable Universal Life administrative system that they first installed at a client in the summer of 1983.

MR. STEVE ROTH: I want to focus today on the significant regulatory developments both at the SEC level and at the insurance department level in the states.

The NAIC adopted in December of 1982 an amended model Variable Life Insurance regulation. In terms of state by state adoption of that model the progress in 1983 was very slow. In fact only one jurisdiction, Delaware, actually adopted the model in 1983. The pace has picked up significantly in 1984, but it certainly is not running away. Currently, there are 11 jurisdictions that have adopted a form of the amended model Variable Life Insurance regulation. They are Arkansas, Connecticut, Delaware, Iowa, Kansas, Kentucky, Maine, Minnesota, Mississippi, North Dakota and Virginia. In addition, there are three jurisdictions that currently have either noticed or proposed a regulation substantially similar to the amended model. They are Indiana, Nebraska and Texas.

Virtually all these jurisdictions, both those that have adopted it and those that are proposing it, have come forth with something that is virtually identical to the amended model. Therefore, from the standpoint of establishing uniformity we are really on the right track. There is one deviation that may be worth pointing out, and that is in Texas, where the proposed regulation does contain some detailed provisions in the actual regulation governing illustrations, non-forfeiture and investments.

As far as the remaining states, there are a number of them, about 13 in all, that have in effect an older version of the Variable Life Insurance model regulation (Alaska, California, Colorado, Georgia, Maryland, Massachussetts, Michigan, Missouri, New York, North Carolina, Ohio, Pennsylvania and West Virginia). It would be particularly important to see those states adopt an amended model within the next year or so. We expect that by the end of 1984 we will see 13 to 15 states having adopted the amended model and continuing through 1985 at a pace of perhaps one or two a month.

One final comment on state regulation -- when the NAIC adopted the amended model in 1982 it appointed a task force to look into three areas that really were not covered very specifically in the model.

The first area dealt with investments. The old model regulation had contained a list of prohibited investments, among them real estate, commodities and options. The amended model deleted all those prohibitions and simply set forth the general standard that the separate accounts supporting variable life products simply need to have sufficient net income or readily marketable assets to meet anticipated withdrawals. The task force is to produce a guideline to enunciate more precisely the standards associated with that general standard.

The second area deals with illustrations. The task force is supposed to come up with some guidelines on when illustrations must be used, what assumptions should be used in illustrations and how guaranteed and non-guaranteed charges should be handled in illustrations.

The third area deals with the applicability of the standard non-forfeiture law. Assumptions and demonstrations that will be required need to be specified.

It is expected that these guidelines will be addressed at the December NAIC meeting and that the guidelines will be adopted at that time. Between now and then, industry task forces, particularly some at the ACLI, are to come up with something by December. In summary, on the state level there is slow but significant progress, and we expect to see continued progress in the months ahead.

As far as the SEC is concerned, back in June and September of 1983, the ACLI submitted a petition for a proposed rule making to the commission. That petition sought adoption of an SEC exemptive rule under the Investment Company Act providing relief from a number of technical provisions of that act. The main relief sought related to relief from the sales load limitations in the Investment Company Act. As written, the Investment Company Act would basically prohibit the issuance of a Variable Universal Life product because the limitations on sales loads are based on actual payments.

Therefore, it was thought important that at the outset an exemptive rule of general applicability be adopted by the SEC in order to provide certainty and guidance in product design.

The proposed petition by the ACLI had really four main objectives relating to the sales load. The first objective was to allow companies to demonstrate compliance prospectively. You do not, in the case of a hypothetical variable universal product, know the frequency, amount, or duration of actual premiums. Therefore, you need tests that will show compliance regardless of actual payment patterns. For rule 6e-2, which is the exemptive rule now on the books for scheduled premium variable life, so long as the policy stays in force, you do know the amount and frequency of premiums that will be paid. Therefore, a different test needs to be put in place for a flexible premium product.

The second objective is to allow back-end or other than front-end sales loads of all different forms and varieties. Rule 6e-2 for scheduled premium variable life now contemplates only front-end loads. We want to allow back-end loads as well as loads deducted from the cash value in whatever form that would be used to pay sales and promotional expenses.

The third goal or objective is to allow additional sales loads upon increases in face amount without requiring additional premiums to be paid.

The fourth objective is to provide basic comparability with scheduled premium variable life products. By that I mean that to the extent that this product can be deemed equivalent under certain payment assumptions to a scheduled premium variable life product, that the dollar amount of sales load that companies could derive from this product would be equivalent to that they could derive from the scheduled premium product.

How did the ACLI petition attempt to achieve these objectives? In terms of prospective demonstrations of compliance on front-end loads, the method used is to test for the amount of sales load deducted, only assuming payment of certain defined guideline annual and guideline single premiums. As far as back-end, or other than front-end loads are concerned, the goal here is to allow a wide variety of charges. The method employed in the ACLI petition is to utilize a so called Economic Value Test. Basically that test provides, as long as you can demonstrate that your policy death benefits and cash values at each duration are at least as good as those you would have under a complying front-end sales loaded policy, your policy is okay. The method used on the third goal (concerning loads on increases) is the so called Cumulative Sales Load test. The basic theory is that so long as the sales loads assessed in connection with an increase, particularly first year loads, are not greater than those you would assess under a separate policy issued at that time in the amount of the increase, then the sales loads assessed upon the increase are okay.

After this petition was submitted in June and September, the SEC published this ACLI petition in November without any changes whatsoever in the form of a proposed rule. It was a rather unusual procedure, one they have used infrequently, in that they published it without endorsement. They really had not studied the merits of the proposal, but they felt it was important to publish it for comment in order to receive any input that the industry or other commentators might have. Moreover, they really had not decided whether the course to follow was to come out with an exemptive rule of general applicability in the first place or to follow the more normal practice of requiring companies to file individual applications for exemption. The comment period ended in March of 1984. About 25 comments were filed. They were generally supportive of the rule and urged its prompt adoption. There were no significant changes or alternatives proposed. In fact, it is probably fair to say the supportive comments that were submitted were not detailed comments. They did not go into any technical detail as to the merits of the proposal, so the SEC is sitting with the proposal with some general supportive comments.

The SEC has been studying the proposal since March. They really have not sought any additional information from the industry on the substance. They have, however, made some pronouncements on the procedures that they intend to follow, and this does have some substantiative implications. Their public comments on the procedures can be interpreted as very positive in two respects. In the first respect, they have indicated that they do intend to move forward with an exemptive rule. They do not intend to leave companies to the undesirable alternative of not knowing what the standards are and having to file individual applications. The second point is that they have indicated they will not recommend that public hearings be held on the proposal. Those of you that are familiar with the proceedings involving scheduled premium variable life ten to fifteen years ago recall that very extensive and tortuous public hearings were held that delayed the proceedings more than a year. We do not expect that at this point, and the staff has so indicated. At the same time the staff has indicated that it will be recommending some changes to the ACLI proposal. They expect to recommend these changes formally to the SEC in November or December of 1984. The recommendation would take one of two forms. It would either be a temporary rule or a re-proposed rule. In either case they will be soliciting further public comments on their publication. The comment period would probably run anywhere from 45 to 90 days, running into the first quarter of 1985. We would not expect to see a final rule adopted until the end of the second quarter of 1985 or perhaps the end of the 3rd quarter.

What is the significance of these procedures? Let us focus first on the temporary rule. The temporary rule would actually have the force of law. Companies would be able to rely on it. We would not need to file individual applications for exemption. At least in theory this would operate to expedite processing of variable universal filings that were made in compliance with that temporary rule. As for the re-proposed rule, it would not have the force of law. Under that approach companies would be required to file individual applications for exemption; time probably would not be saved in that respect. So long as the product design was in conformance with the re-proposed rule, the staff has indicated, preliminarily, that it would act upon and approve individual applications for exemption. We do not have a strong indication one way or the other which way they are heading on this procedure. They have not yet made up their minds. One important point is that under either scenario, what they anticipate is requiring that companies getting products approved agree that they would comply retroactively with the terms of the final rule when it is adopted. They would have to do so within a specified transition period. It is open to conjecture how long that transition period would be, probably somewhere between 6 and 12 months after adoption of the final rule.

I view these steps taken or proposed to be taken as indicative of a positive response by the SEC. They do want to accommodate the industry and provide some certainty here. At the same time the proposed procedures do indicate that some caution is being exercised by the SEC because they do feel they are operating in totally unchartered areas from the sales load regulations standpoint. When similar procedures have been used in the past, it has had the effect of causing registrants to be a little more circumspect about moving forward at break-neck speed.

With regard to substantive questions, let me venture a couple of observations as conjecture. Although possible, we do not see the re-proposed or temporary rules containing major conceptual changes. It seems probable that the re-proposed rule will still have this guideline premium concept contained in it. Somewhat less clear is the inclusion of the Economic Value Test for other than front-end sales loaded products and the tests for increases in face amount. Then again, we are not aware of any alternatives being proposed or discussed. It is likely that some of the actuarial assumptions contained in the proposed rule will change. We would not be surprised if we saw the '58 CSO and 4% assumptions used in calculating guideline premiums changed to perhaps '80 CSO and 6%. But again, there have been no formal announcements in that respect.

Let me spend a couple of minutes on rule 6e-2 because we do have a little clearer impression as to how they see their current regulation of scheduled premium variable life fitting in with the flexible premium products. At the same time that they are going to re-propose rules under the Variable Universal Life product, they do expect to propose consistent changes to Rule 6e-2 which now provides exemptive relief for scheduled premium Variable Life Insurance. The staff is leaning toward expanding the scope of Rule 6e-2 so as to apply to all products that do not need guideline premiums to demonstrate sales load compliance. Therefore, amended 6e-2, according to current staff thinking, would apply to all scheduled premium variable life products including the Equitable and New York Life designs. It would probably also apply to fixed premium variable universal life products. It would apply to flexible premium variable universal life products that charge no more than 9% as a sales load at any duration. It would also apply to so called hybrid products, products that have both scheduled and flexible features but that have enough scheduled features so that you do not need to make some assumption as to premium payment levels in order to demonstrate compliance with the sales load limitations.

One point we think is going to be covered in both the amendment to Rule 6e-2 and in the re-proposed or temporary rule relates to the mortality and expense risk charge that has been and will be assessed with this product (asset charge or the spread between earned and credited rates on a fixed product). Basically, under the existing regulation of variable life, the SEC has not focused on the charge. The reason is that under the old Variable Life regulation in the states, the charge was limited to 50 basis points. When the amended model regulation was adopted, the 50 basis point ceiling was lifted. The SEC is very cognizant of that. They feel that under the circumstances it is mandatory that they become involved in regulating the charge. This is important from a product design perspective.

It is likely that the SEC will require that the mortality and expense risk charge be justified in one of two ways. In the first way companies would have to show that the charge is within the range of industry practice in order to be deemed reasonable. That is the basic standard that the SEC would apply. The second method of demonstrating compliance would be to show that the charge is reasonable in relation to the risks (mortality and expense risks) assumed. As to the first standard, the current SEC staff thinking is that where you are showing that the risk charge is within the range of industry practice for existing variable life experience, that means 50 basis points since no one has been able to charge more. Although we are still in a very early stage, they have looked upon something in the neighborhood of 60 basis points as being in the upper end of that range of industry practice. As to the second standard, reasonable in relation to risks assumed, initial indications are that the SEC will be very cautious and very circumspect in approving charges on this basis. Initially they are going to be reluctant to approve charges as high as those that you now find in variable annuity products, that may range sometimes between 90 and 140 basis points. We are probably going to see things moving very slowly on that although if this is raised in the re-proposed or temporary rule, I would expect that there will be a strong industry comment on it and an opportunity to provide input to the SEC before they finalize it.

In any event, whatever happens to the numbers, the contemplated SEC procedures would require that an actuarial memorandum be prepared and the initial registrants probably will have to submit it to the SEC for their review. A memorandum would justify the level of the charge. Probably, with subsequent registrants all that would be necessary would be that the memorandum be kept in the company's files available for SEC inspection upon request.

Finally, let me just spend a couple of minutes going over what companies have been doing during the last year during this period of considerable regulatory uncertainty. The SEC has indicated that during this interim period, they will process all Variable Universal Life filings that do file for individual special exemptive relief but that do not require the kind of sales load relief that would be contemplated by the proposed rule. Put another way, they would process products that can demonstrate under all premium payment assumptions, assuming the policy remains in force, that the sales load would fall within the percentage limitations now contained in existing laws and regulations. If you are talking about a purely flexible product, what that basically means is that one can charge no more than 9% as a sales load at any duration.

With that pronouncement, there have been three strategies available to companies. The first strategy is simply to go forward with designing a product that would be sufficient to cover your traditional sales commissions and sales expenses and wait for the SEC rule. A company could file on that basis (as some companies have filed), but the SEC would not review it until they have made some substantive decisions on the proposed rule. The second approach would be to file for special exemptions and to get the SEC to process them. There are two ways that companies appear to do that. First is to design a product that has very low loads from a sales load perspective, particularly the first year, and target your product at the stock brokerage or single premium market. The second option is to design a hybrid product that contains a mixture of scheduled and flexible features and to request exemptive relief under Rule 6e-2. The third approach is to go ahead and launch a fixed premium product along with an Equitable or New York Life design. There have been about half a dozen new scheduled premium variable life filings this year, so it appears that companies have been following that approach.

So far this year (my information being as current as about a week ago) there have been ten filings by eight companies. Acacia has made two flexible premium VLI filings. IDS Life has filed a product that is totally back-end loaded and would need the relief provided by the proposed rule. Keystone Provident, Life of Virginia and Lutheran Mutual have filed products that are either front-end loaded or a combination of front and back-end loaded that are nevertheless at a low load level that could conceivably get approved before the SEC takes action on the exemptive rule. Prudential, through a subsidiary, PRUCO, has filed a product that could be termed a hybrid product that has both scheduled and flexible premium features. It has a combination of front and back-end loads. The back-end loads are based on actual premiums, so there is no need for an Economic Value Test. Security Benefit and Travelers have filed products that would require waiting for the SEC rules. Security Benefit is primarily a back-end loaded product. Travelers has two front-end loaded products. One of them is a single premium product.

In terms of these filings and the progress being made, two of them, the second Acacia filing and the Prudential filing, have received what amounts to SEC approval on their exemptive application. They have not yet received final approval on their prospectuses and their registration statements. Therefore, they are not yet able from an SEC perspective to sell, but they are very close, and we would expect to see final approval coming for both of them in the next several weeks. Probably, a couple more of those products might get approved this year. That is all we expect to see. In terms of new filings, we will probably see somewhere in the neighborhood of half a dozen variable universal filings during the rest of this year. I expect that you will see a considerable number of filings, perhaps as many as 25, filed in the first quarter of 1985. A lot of companies are waiting to see what happens when the SEC comes out with its pronouncements on how it is going to comment on the industry proposal.

MR. STUART GRODANZ: My real purpose here is to describe the basic product development decisions that you need to make in order to enter the Variable Universal Life market. First, I want to do a quick review of our product background and how we came to be where we are today. We have had life insurance and annuities forever. We have had variable annuities for a fairly long time. Variable Life Insurance has been around as an idea for ten to fifteen years, and we have had Universal Life for a few years now. The product that we are talking about is nothing more than a summary of the last two products, the Variable Life and Universal Life products. It is a very natural progression.

Think about the environmental background for a minute. We know that both our customers and our distributors are becoming more and more investment conscious than they were some years ago. We talk a lot about financial planners and broker-dealers. I am not sure what the number is; perhaps there are 50,000 people around who call themselves financial planners. The product we are talking about is a natural to these people. There is another aspect of the environment that is important. It drives us and affects the way we think about this product and about product development in general. Three or four years ago interest rate spikes saw billions of dollars leave the life insurance industry in policy loans and surrenders. Why? Because the customers and the agents felt very strongly that there were better deals out there for them. They were right. We became very much aware of our asset risk and of the changing ways that our products were being viewed.

About the same time that we were entering the Universal Life business, Universal Life brought about a change in the way we think about sales. Replacement used to be a dirty word. We have all heard some talk about twisting, and it has strong negative connotations. Universal Life, mainly because of its premium flexibility, has changed that. I recently heard one of our marketing people refer to replacement of old traditional permanent policies with Universal Life. He called it "The Enlightened Liberation of Assets". We have to keep this in mind as we design Universal Life products as well as when we design Variable Universal Life products. There is a good chance that your company's Variable Universal Life product will be used in replacement situations. If your agents have access to customers who did not switch yet, who have waited for "the real investment product", it is likely that this product will be used in that way. If that is the case, be sure that your product design and product rules lend themselves to this use. Questions such as what kinds of loads or commissions you will have on dump-in monies is a level of detail that I do not want to get deeply into, but it is something that you have to think about. Instead, I want to describe the thought process that we went through at Travelers in designing our product as well as some major decision points.

About a year and a half ago, we went through a process and decided, yes, we do want to develop this product. Where were we? We already had Universal Life, we knew that we were spending more and more resources developing top notch financial planner type outlets for our business. We talked at that time about being the first, or among the first, to come out with this product to give us a market edge. We also knew that it was a tremendous systems, administrative, legal, and general development effort. We had a team do a feasibility study both from the traditional product point of view as well as from the administrative and systems point of view. It was decided that we would move ahead with the development of the product and we would develop our own system. We developed the product along the general lines of our existing Universal Life product that was available at the time. We decided that the loads and commissions should be relatively high, keeping them in line with our traditional form of distribution. That is, we thought about how we would sell our product, and we knew that we had to meet our agents' needs. Otherwise we would have a fine product, and no one would sell it. As we worked, we realized that we had an extra set of constraints that we did not have with Universal Life when considering loads and surrender penalties or deferred sales charges. We had become accustomed to thinking about how these charges would meet non-forfeiture requirements. The extra complication was remembering to keep the combination of charges in line with what the SEC will look upon with favor.

In considering our market and our distributors, we knew that our Universal Life product was not being sold by securities dealers, but was instead being sold by life insurance and multiple line agents, a more traditional way of distributing life insurance. We intended to develop our variable universal product for the same distributors. It is still life insurance, and it is still being sold based on some kind of life insurance analysis, and it will still be our regular life insurance agents who will sell it. Therefore, we chose a product design and a set of loads and commissions that match up with those facts. It is, however, reasonable for a company to go through the same thought process and reach the opposite conclusion. Consider for example, a company that we are affiliated with. They have had a single premium interest sensitive life product for a few years. It is a product that looks something like an investment and is designed along those lines. For the most part, it is sold by securities dealers and stock brokers. In fact, they do have some sales that are produced by the more traditional insurance agent. Those sales are different enough that they refer to those people as their mortality agents. I always thought of arsenic as a mortality agent. It is a funny name, but it drives home the point that their principal distribution force is different from the traditional one. Thus, when they go through the same thought process, they would reach a different conclusion on product design.

We did realize, when we made the high commission, high load decision, that it would probably mean that we would not be the first product on the street. However we did intend to be among the early entrants to that market and among the first with a product that fits in the traditional life insurance style.

I do not want to get into too many of the finer details of pricing and profit analysis. I suspect that most people in this room are very familiar with pricing and analyzing regular Universal Life Insurance. We find that in analyzing this product we have very little extra work to do. In fact, we have a little less. At Travelers we have probably designed and priced 15 different Universal Life products since we entered the market two and a half years ago. That does not mean we have put that many on the street, but that we are quite familiar with the work involved. This was simply one more. With our standard Universal Life products we spend time analyzing the whole product including our asset risks. What can happen to us when the market value of our assets is down? How much can we lose? How much extra margin do we need to build in for this kind of risk? While that answer varies from product to product depending on what our investment strategy is and what surrender penalties we might have, it is clear that we always have some risk, and we make an attempt to translate that risk into a number of basis points. It is difficult work; I think as an industry we are just learning to do that kind of work. We do try to translate this risk into a risk charge at some confidence level. So here we have a Variable Universal Life product where instead of investing in, perhaps, five year corporate bonds, with no market value adjustment at cash out, we are investing for the customer in stock market or similar type investments. The customer is the one bearing the investment risk. What do we have? One less pricing problem. The customer has one extra worry. From a pricing and profitability analysis point of view, I view it as just another Universal Life product but a little bit easier to price.

There are some extra things to look out for. There are some extra expenses. The whole process that Steve described is time consuming and is an expense. There are a lot of prospectuses. We use a lot of them for each sale, and they cost money. We do a lot of things, spend a lot of dollars here and there, that we do not normally spend with a regular life insurance sale. You have to take that into account, but it is not all that difficult. Something else that we have thought a little bit about is that there is a group of people called market timers, and they could whip your portfolio around pretty quickly for you. There is not a lot of investment risk involved there, but there could be a lot of expense involved, and you may or may not be charging appropriately for that expense. These are minor points. All in all we have just another Universal Life product.

Essentially, we have said that we need to keep the product consistent with the distributor and with the buyer. Those two are very similar constraints. The big decision relates to loads and commissions, but there are other things that we can do. One way to try to maintain the agents' comfort level is to keep the product as similar as possible to the Universal Life product that they have become accustomed to in basic product design. It does not have to be exactly the same, but similar in nature. That could help keep the comfort level up so that when you do introduce a product you will actually get sales. You will not be on a one year or two year learning curve. Alternatively, you might have a fund option that is similar to what they are used to. Perhaps a general account version or something that replicates a general account. That might be a way to raise comfort levels. At this point we have not taken that route, but I promise you we have talked about it.

We had two actuaries work virtually full time for one year in the product and administrative development process. Another actuary spent perhaps half his time. There were, obviously, administrative people, systems design people and of course the programmers themselves. It was a tremendous effort: systems design, computer systems, administrative procedure development and testing of all these. The actuaries involved were also working on some product pricing. 75% of the actuarial resource in the project was devoted to administrative, computer systems development and testing. Perhaps 20% was devoted to the traditional product design phase, and 5% was devoted to non-routine legal matters that we do not normally have to do for a regular life insurance product. Also, time was spent reviewing product input for the perspectus and SEC filings. We spent three or four times the usual actuarial product development effort on non-traditional jobs.

In summary, this product is a natural fit for our current mix of business and the way we do business. It does not present a significant new pricing challenge. We just have to remember who will buy and sell the product and match the product with what they will want. Transferring some investment risk or asset risk to our customers should be reflected in the price. This product offers more opportunity for administrative foul-up than any other we have ever developed.

MR. DONALD PAQUETTE: My task this morning is to try to identify for you those items of administration that are peculiar to Variable Universal Life (VUL). They are not the same problems associated today with Universal Life processing with which a lot of companies are currently familiar (i.e. system implications of unbundled processing, monthiversary calculations, systematic calculation and monitoring of guideline premiums, data capture systems for all reporting and auditing purposes, and the potential system costs associated with the new model valuation regulation). What is left to talk about? With Variable Universal Life, the key items are the registered funds, regulatory aspects, reporting requirements and timings of all transactions in and out of the funds.

This morning I would like to address those of you who will be or are designing Variable Universal Life type products. I would like to point out that not only do you have all of the problems with VUL that you have with any of your current non-traditional products, but now with VUL you have to take a careful look at even the simplest of transactions and how the administration systems have been designed to support appropriate timings and audit trails. Let us assume that you have solved all the hard core problems - all the nuts and bolts processing of basic Universal Life. With Variable Universal Life and its registered funds, the most important consideration now is the timings and audit trails of every movement of money in and out of those funds. Every problem that you have had in administering a current non-traditional product now becomes so magnified and in such a degree of complexity that you will have to have automated systems to deal with them. You can not expect even the simplest of transactions to be handled manually. Facilities to correct mistakes must be in place if you are going to be successful with Variable Universal Life.

Consider what makes a successful administration system for any product or any company or any country. They are the needs to keep it simple at the clerical level, have timely reporting mechanisms and have good audit trails. People who are not trained in an actuarial science have to understand what it is they are doing. When they make a mistake, they have to have a way to correct that error.

Those companies that will be successful in dealing with Variable Universal Life are the ones that master four basic points. First, in designing your product, let it be critiqued by those people who will have to administer it on a day-to-day basis. Second, in designing flexibility for the policyholder, make sure you have a plan to administer that flexibility before you promise it. Third, take a good hard look at all the data that are going to be necessary to meet all your reporting requirements and make sure you have a plan for that reporting. Above all else, make sure people have a way to correct their errors.

Non-traditional products represent a fundamental break with the past. We are faced with lower profit margins and with much more complex administration which results in greater administration expenses.

Careful analysis of the timings of all transactions and changes occurring in addition to setting up a plan for audit trails of everything that is happening to the policy is necessary. Otherwise, you will never be able to explain what happens on a policy.

How do we proceed? As these products are designed, how do we protect ourselves from ourselves? First, talk to people. When you sit down to design your policy, send a sample of that design to the people who are going to work with it on a day-to-day basis. Let them poke holes in it.

With Variable Universal Life you have a new element of risk on the investment side. This occurs during the free-look period of the policy. If, for example, you have invested money in a separate account that is fairly volatile and you have to return that premium to the insured at the end of the free-look period, you may have a loss. You may also have to report a loss when you cancel units. In designing this product you might decide not to take that risk. To eliminate the risk of the free-look period you design a fund that basically guarantees the principal. You might want to put the money in the general account and let it be interest bearing like on a UL-1 fund. You might have some new type of guaranteed principal fund or money market fund. In designing the product, when the policy is first issued, all money would be deposited in this special account. At the end of the free-look period the system would automatically transfer that money out and deposit it in the accounts that the insured has selected.

Be careful of an oversight at this point, because the timings here are very important. When is the end of a free-look period? Part of the measure of a free-look period is a certain number of days from delivery of the policy. Have you, as a company, ever recorded the delivery date of a policy? What is going to happen to you when you go out and ask your agents to tell you when they deliver the policy? Will you ever know? Will you know in time? Because you have committed yourself to transferring money at the end of the free-look period from one account to another, where these products are registered, you must do it on that date that you indicated. When you send out confirmation notices, how well will that agree with the policyholder's view of when those units were purchased?

As another example of timings, consider automated premium payments, electronic fund transfers or pre-authorized checks. Take a good hard look at what your system currently does in processing these automatic premium methods. If in your billing cycle your pre-authorized checks, as you produce them, concurrently assume premium deposit to the policy, what happens to you if in your plan for valuing accounts you do not plan to know today's unit value until tomorrow? What is going to happen is that when that billing cycle runs, every single premium payment will be rejected because the unit value is not there for it to process correctly. Do not wait to consider these timings until you have tens or hundreds of policies in force. You will not have time to react. How fast can your data processing department react to rewrite that kind of a system? Do not expect that you are going to manually process even premium payments when you have multi-directed funds with unit values and their associated loads. In considering this timing for pre-authorized checks you may sit back and say our system does not do that. We do not have a problem. Well, maybe your system, when it produces a check, creates a turn-around premium transaction that will go into tomorrow's cycle, or the next cycle when you can then claim that you are depositing money to the funds on the same day that you have the money to invest in separate accounts. Be careful with wording put in your documentation. Be careful of what you are committing yourself to because you have a similar problem of timing on withdrawals. If you accept a withdrawal transaction today, will you process it today or tomorrow? Tomorrow is when you will actually withdraw that money. Think just at the policy level. What happens to monthiversary deductions for the cost of insurance when you may not know today's unit value? Must you wait until tomorrow and run everything a day behind for that part of the processing? The timing of all these transactions and processing has to be thoroughly studied by you and your administration before you can live with this product. These problems are not difficult to solve. They are very easily solved if you will just match your policy with your system and your system with your policy.

My second main point today regards promising product flexibility before you have in place a plan to deliver the administration of that flexibility. With traditional policies computers represented ways to handle huge volumes economically. There always was a thought with traditional policies that the worst thing that could happen was that while volumes were small, we would manually administer them. This is no longer the case with Variable Universal Life. Let us look at some fairly typical provisions. First, consider non-scheduled increases with separate underwriting classifications. Each time the insured requests an increase, you can underwrite him for that increase so that multiple pieces of the policy each have separate rates associated with them. Second, the back-end loads decrease by individually underwritten pieces. Third, partial withdrawals recover a pro-rata share of full surrender loads. Fourth, to protect against anti-selection, withdrawals may reduce the face amount. I have seen provisions similar to these in some companies where administration systems were not in place for them and no plans were being made to handle them.

Suppose you add a provision to the product design that will not allow non-scheduled increases for five years because you cannot currently administer increases. If you do not allow non-scheduled increases for five years, none of these things are a problem yet, and they would not be for five years. Five years is a long time from now, so we do not have to start thinking about how to set up our systems to handle this. This is especially true because we have so many other data processing projects going on. Unless your basic design is such that you can monitor every single piece of that policy, individually and in conjunction with each other, five years from now when the first non-scheduled increase happens, you are probably looking at a full systems conversion to allow those increases. This is especially true if you want the system automatically to control and process partial withdrawals. At that point you may have to rethink your entire method of monitoring for guideline premiums when a withdrawal is processed on such a policy.

We have quite a bit of experience in dealing with non-traditional policies in the industry. I have found that, for most companies who were not prepared to automate certain functions in their product design, as soon as they decided to handle a particular policy manually, that policy is manually handled until their systems are prepared to automate those functions. Do not put any provisions in your policies unless you have a plan currently worked out for its administration. You are in fact, mortgaging your data processing department and your company if you expect to administer manually thousands and thousands of policies that are unbundled.

With Variable Universal Life, we have a new set of reporting requirements. The fact that all activity in and out of those funds must be confirmed makes it very important that you do not assume that you will be able to satisfy all the reporting requirements without first investigating the details your systems are capable of handling. This is something that could easily be an oversight in the design of this product. The volumes of data that Universal Life or Variable Universal Life systems will produce are just staggering. Depending on the mix of funds and insurance elements of a policy, a Variable Universal Life policy can produce tens of times the data produced by a traditional policy. Think about a fairly simple VUL policy. It might have five funds, and five insurance elements. If you sold the traditional monthly pay policy, you would have two accounting records a month, debit cash, credit premium. With the Variable Universal Life policy you will have those two, but you will have five allocations and transfers to the separate accounts. You will have five deposit and load transactions. You will have five monthly insurance cost transfers from the separate accounts, and possibly five transfers from the separate accounts for administrative loads. If you use double entry accounting to track all the pieces of money moving in and out of the policy, you will easily have twenty times the volume of data on a VUL policy that you have on a traditional policy. Make sure you test your system design and let your administrative people model your systems so that you can make an informed business decision on the administrative costs associated with this product design. Do not assume that computers are so fast that they can process so much data that the cost will be negligible. It is true that unit costs decrease as volume increases, but your plans have to be in place to deal with those volumes.

My last major point in the administration of Variable Universal Life is that you must have a plan and an automated system in place to let people correct their mistakes. Money is moving in too many directions on even the simplest of transactions. You will not be able to record the data necessary to monitor and calculate the values of the policy on a manual basis. The system has got to do it for you. There has been a great deal of talk about un-do re-do systems for processing non-traditional products. With Variable Universal Life they must be in place. Without these systems the expense of calculating gains and losses will become incredible. There are just too many calculations and too much data to sort through to get the correct values on the policy.

With all of our experience in designing systems and struggling through the automated administration of non-traditional products, there is nothing magical or mysterious about these four basic points. Talk over your design. Do not assume that things are easy and obvious because timings are critical with Variable Universal Life. Sit down with your systems analyst or the people in policyholder service and let them look at what you are proposing and what you have put in the prospectus about the processing requirements. Do not put anything in unless you know exactly what your plans are for processing that feature. Model and test this product and its design. Be informed when you enter the marketplace, so you know what your systems requirements are going tQ be, near-term and long-term.

Companies are required to spend a great deal of time and effort because of the flexible nature of Universal Life. Companies allow people to change any thing at any time. Death benefits can go up and down at any time, coverage can be added and taken off at any time, premiums can be paid at any time, and now with Variable Universal Life, money can go to any number of accounts and be transferred in and out at any time. A lot of companies perceive this flexibility as a burden in the administration of the policy. They try to keep people from exercising too much of this flexibility: transferring money, withdrawals, loans, multi-directed deposits, and special user requested transactions.

How do we keep those costs down? The thinking right now seems to be that we will only charge those people who want to exercise these options. We will try to put fees in the policy, so that we will discourage them from using the flexibility that is in the policy. Perhaps we will allow only two transfers per year, and then after that we will charge $10.00 a transfer. We will allow somebody to make four loans a year and afterwards charge $15.00 for every loan. We will let people decide the allocation of premium payments only at the policy anniversary. Any of these provisions taken individually might make you think that you can monitor and protect against a lot of work on the accounts. However, you have to look at them in conjunction with one another. A policyholder can take out a loan and repay it and in effect transfer money. If you are not allowing more than a couple of withdrawals a year from the funds, perhaps an insured can change the premiums on the policy to do in effect what he wants with the funding level of that policy. If you have an administration system that is monitoring and tracking every little piece of money that flows in and out of the policy and every change that is processed on the policy, you have the ability to track and monitor those people who are overloading the system. You have a mechanism whereby you can make charges for transactions. However, does this mechanism cost more than it can create in charge income and reduced expenses?

Why single out special transactions? If there is an administrative charge associated with transactions, let us put that in place. Let us not say that a withdrawal transaction costs more than a loan transaction or costs more than a directed deposit transaction. With Variable Universal Life you must confirm all transactions. No longer will you just receive premium payment and deposit it. You will have to tell the policyholder what you have done with that premium and at what values you have purchased units.

People have talked about nuisance items on Universal Life or Variable Universal Life policies. What happens when a policy's cash value becomes very small? Do you still allow it to remain on a policy? What happens when a premium is small? Do you allow it to be distributed to more than three funds that are on the policy? Think very carefully, what is a nuisance item? You will have to have a system that will process any type of transaction in a very user friendly automated fashion. It will not matter to that system whether an amount is small or large. Why concern yourself with whether or not transactions are small? I have found that many companies spend a great deal of time trying to make decisions in these areas when they should let these things work themselves out in the system as one models and tests the design of the policy. Do not force into your design those things you think might happen, but wait and see what really does happen as you model your policy and work your product design around it.

MR. JOHN MONTGOMERY: In California, we had been waiting for enactment of legislation that would enable us to promulgate a regulation. That has been done this year, so we are currently in the process of developing a regulation. Because of the lengthy process to promulgate a regulation in California, it probably will be 1985 or maybe even 1986 before we actually have one. We have a lot of bureaucratic red tape we have to go through to get these things done. I would like to see a bulletin go out to speed it up, but I do not know whether we have the authority for that.

A number of states mentioned today have not yet done anything. Texas is just thinking about it, and Maine has actually gone through this process. But all the other states represented by the members of the actuarial task force who have worked with this product are having problems. There are a number of questions that we are asking the Universal Life advisory committee. Primarily, the questions deal either with the Non-Forfeiture Law or with Universal Life where the cash values exceed the reserves. In the latter, we wonder if the reserve formulas are adequate. With respect to Non-Forfeiture values, it is the consensus of the actuarial task force at the NAIC that a model retrospective non-forfeiture law should be developed for such products.

MR. RICHARD KLING: We filed a product, we have a sales force that is dually licensed for both life insurance and securities, and everybody tells me that we have got the perfect situation for Variable Universal Life insurance plans. I started talking to people about market positioning. Where are we going to position this in the market? We talked to agents and sales people about putting a variable side on Universal Life, as was done with the variable annuities. Their response was that it will not have any minimum death benefit anymore and this does not sound like insurance anymore. They ask if there are some other guarantees in it. The answer is "not really". It offers several investment options. I talk about money market funds, bond funds, and those sound good. I start talking about several different types of equity growth funds. That they do not like because the product turns capital gain income into ordinary income by deferring it. We have a problem there, but we can probably overcome that.

They want to know if commissions will be lowered. They assume it is going to have the rear-end load concept similar to Universal Life. I am not so sure about that anymore. A rear-end loaded product must get revenue from someplace. Right now we get revenues from spreads, and from the insurance charges. I heard this morning that the asset charge may be limited to 50 or 60 basis points and that the insurance charges may be limited to 1980 CSO insurance charges. I start wondering where am I going to get the revenue from. Am I going to be able to make any money on this product? Can I really offer a variable side to what is perceived to be a very good product for everybody involved, the fixed Universal Life Insurance plan with no front-end load? All of a sudden I am not sure I can do it. I am not sure I can make any money if I can figure out a way to do it. I have a real dilemma. I have not found the place for Variable Universal Life that I thought I had. I wonder if anybody else can identify with this.

MR. HAGSTROM: I do. This is the reason we said it. We can hope the SEC will ask for comments rather than acting without gaining those comments.

Let me speak to the issue of converting capital gains to ordinary income when the policyholder surrenders the policy. If the policyholder does not surrender the policy, but just moves money from one fund to the other within the policy, one can hope that that will not be a taxable transaction. Then the policyholder has an advantage over a mutual fund where he would be taxed.

There are a couple of other tax issues one should be aware of. First, the recent tax law passed in the United States says that when a policy qualifies as life insurance, a variable product only needs to qualify under the various tests as often as you change the face amount, but at least once a year at a minimum. To the extent that there are cash value spikes from time to time that might be out of step with your death benefit, it does not create a problem.

In the tax law they have extended to Variable Life Insurance the past tax treatment of qualified variable annuities. This is to say that at the company level for tax purposes one does not recognize gains until they are realized at the company level. To the extent that one passes those unrealized gains on to the policyholder, they have now lined up the treatment of the deduction for increase in reserves with the realized or unrealized capital gains and losses. That removes a problem that might have been there before.

MR. ALBERT CHRISTIANS: I worked on a variable product about a dozen years ago, and the reason we had a variable product then was to protect the policyholder from inflation. Now that seems to be completely forgotten. Now the reason seems to be to protect the company from the asset valuation fluctuations. I can not see why an individual policyholder who has a diversified set of investments would want to put his volatile investments together with his insurance policy. He might want to put some of his more secure investments together with his insurance policies since he is going to have long term needs for insurance. It seems like a product in search of a problem. A couple years ago, the Society of Actuaries developed a life company model called the SOFASIM program. The architecture of this is similar to a transaction processing program. It occurred to me that for products like this, this is a very good way to do your profit testing at transaction processing mode. This would prototype your administrative system in the profit study program itself. By actually prototyping the administration, projecting it through many years, simulating large numbers of transactions over a long period of years and then measuring their financial impact on the company, you could do your profit studies, your product design and your systems design all in the same process. I wonder if any of you could comment on this strategy.

MR. GRODANZ: I would like to address the first comment. I do not think we are talking about a product in search of a problem. We are talking about another option. We are not talking about just protecting the company on the asset side.

MR. ARMAND DEPALO: Guardian is a supporter of a career agency force. This product causes us a problem from the career agent's point of view. We train new agents into the industry. We develop them. They are not SEC licensed when they first enter the industry. This product is really for the more developed agent. There are some very basic questions that you have to answer if you are not in the brokerage or the independent agent market. If you are selling a product that is so much better than what an agent can sell when he first enters the industry, is he going to replace all of the business when he finally becomes SEC licensed? Can you finance an agent into the business with this product? Probably not. Does this product force you to answer the question, "Is the career agency force the way you are going to be marketing business five or ten years from now?" With the introduction of level commissions or even, in some companies, fees for services with no commissions on a product, where is the source of new agents into the business? Is it in transition, or is it in destruction? No one really knows the answer right now. The established mutual companies have to address the question of what are they going to do with the career agency force they have invested tremendous amounts of money in. Is there anyone on the panel who would like to answer that question?

MR. GRODANZ: Travelers does not have a big career agency force. I do not think we would look at the problem the same way you would. However, I do not think that a product like this necessarily means either finding somebody else to sell your business or getting out of the business. It probably does mean some changes in the way you go through that first year or two of training. Perhaps you head for the full licensing earlier, or maybe you have to change the emphasis in the training. I do not agree that it necessarily means everything that they sell in the first five years is going to be replaced in six or ten years. It does mean some adjustments in the way that you train.

MR. ROTH: From a legal perspective, it is going to be easier for career agency shops to get into this market than it is for PPGA or broker companies. From the standpoint of broker-dealer regulation and having an agency force that is qualified to sell these products, the problem that the PPGA and broker companies may run up against is one of finding agents that they will be able to sign up to sell their products. Once you get into the realm of SEC and NASD (National Association of Securities Dealers) regulations you run into problems in signing up agents who are already licensed with other broker-dealers. Basically, the NASD requires you to obtain the consent of the other broker-dealers with whom the agent is already signed up before you can sign that agent up. That can lead to all sorts of problems.

MR. PAUL SMALLEY: My question is aimed at Stuart. It involves two points. The first you have mentioned already, is that the insured is given the investment risk, and the company's margin should be reduced and perhaps transferred to the insured. The second point addresses the proposal system. I am assuming that there would be a similar proposal system available on personal computers or micro computers to illustrate such policies. My question is how would the proposal systems treat the various UL and VUL policies in a particular portfolio? Would you want to be able to directly compare the results under favorable or unfavorable conditions?

MR. GRODANZ: I think it is perhaps more of a legal question than an actuarial one. The big legal question is, can you be as free with the way that you do your proposals on the variable piece as we are when we do the regular UL piece? I know that there are proposals run on UL at a 12% level interest rate, a 10% level interest rate, even at 10% grading up to 15% interest rate. What if somebody spikes to 20% and goes down to 4%? There are all kinds of things done out there. That probably will not be done on the variable piece.

MR. ROTH: Right now the practice for Variable Life which we expect to continue for this product, from the SEC's perspective, is that you can only illustrate hypothetical gross rates of return of 0%, 4%, 6%, 8%, 10% and 12%. The SEC will not allow you to illustrate above a 12% gross rate. A gross rate means that you would have to net out your investment advisory fees and your mortality and expense risk charges. The only other possibility would be illustrating your past performance, but only for as long as you had it. You would not be able to project that out.

MR. JOHN SCHREINER: Steve, you mentioned that you expect the SEC staff in the next couple of months to go down one of two roads. The first is a temporary rule which would have the force of law, and the alternative is to come out with the re-proposed rule where we will need individual applications for exemption. You mentioned the key here is that the company might have to comply retroactively with either alternative. Could you expand a little bit on that? Might there be a refund of sales charge or an adjustment in asset charge?

MR. ROTH: Conceivably that is true. There is very little precedent for this. We have looked into it, and there has been nothing in this area at all. There have been a couple of temporary rules that the SEC has issued in the last five years. They have involved such things as shelf registrations. It is conceivable that if they reduce the level of charges that are allowable, one might have to refund charges already taken. I will be very surprised, however, if the final rule that they come out with is more restrictive than what they re-propose. I do not see that as a significant problem. We will have to see what the re-proposal looks like.

MR. JOHN LONGMOORE: Somebody asked whether the structure of the product or the philosophy had changed. I think he must have thought we were very naive back in the early 1970's if he thought we did not realize we were transferring the risk and the profitability to the policyholder. We certainly realized that. I think the Equitable did as well.

The other comment made was whether you should sell this through a career agency force. The only way the fixed premium variable life is being sold is through a career agency force. We have tried to sell it through independent marketers, and you get tied up in licensing problems. You get the problem of the person having to sell through a single broker-dealer, getting permission of the other broker-dealer, and most of the people have affiliations one way or the other. These have been a big disappointment to us. Essentially, virtually all our sales have come on the career side. As far as financing agents, there is really no difference between a variable product and a fixed product. You are still going to have to finance the agent if you are going to have a career force. The only new problem is that the SEC is not going to give us enough loads to be able to do that. That is a different issue from anything to do specifically with the product.

MR. GRODANZ: One point you raised was with the single registration and single broker-dealer. You are in a career shop; I'm not. This is one of the times that I say it would be easier if we looked like you. However, we have been in the variable annuity business for some time. We take these independent agents with whom we do business and say to them here is our line of variable annuities and here is what you have to do to be able to sell them. We do say to them, you have got one broker-dealer and if you are doing business through a bunch of others, do not come to us. We have been successful doing that. It has probably cost us a few sales along the way, but we have stuck to it, and we intend to stick to it with this product. I think you are right. I think the career shop is probably the smarter or easier way to go.

COMMENT FROM THE FLOOR: You raise another interesting question, and it is one which troubles all of us with a career agency force. That is; how much of our business is being written by our career agent, but for other companies? Not necessarily the Travelers, but, lots of companies out there. In the equity field you have a lot more control than you do in the life field. They can not write if you do not give permission. They can not write Variable Life or variable annuities or mutual funds with anybody else but with you.

They can not write with another broker-dealer if they are registered with you. I think a lot of companies would look at that as some kind of advantage because I know we feel we lose a lot of our business to other companies in the fixed life side.

MR. GALE HASSELMEIER. One of the things that I have been following has to do with the frequency of the confirmations, and whether we might be able to do quarterly confirmations with normal policy transactions, such as payments and monthly deductions.

MR. ROTH: There has not been much done unfortunately. I think the attitude that companies are taking is that they are assuming one will have to confirm everything. On scheduled premium variable life riders, companies have been confirming premiums annually. Transfers and policy loans are being confirmed on an immediate basis. The SEC theory for granting them that relaxation is that the policy mechanics do not depend on when the payment comes in under the scheduled premium products. Under this product the premium is going to relate to the policy mechanics because it is going to be credited right away. Therefore it is unlikely that we will get as much relief as we got for scheduled premium Variable Life. I think you will see companies seeking something like you suggest, quarterly or monthly, but we do not have a fix at all on whether we are going to have a shot at it.

COMMENT FROM THE FLOOR: I have a question for Mr. Roth. We seem to be all taking a lot of comfort from the fact that at the present time regulation allows a person to be registered with more than one broker-dealer only if he has permission from all the other broker-dealers with whom he was registered. How long do you think that will stand up when some of the agent organizations start fighting it as a restraint of trade? After all we have lost a suit in the state of Florida on rebates.

MR. ROTH: This is a long standing position. It is nothing really new. At the SEC level you have some flexibility if you can get the other broker-dealers to agree. However, at the state level, if your agents are selling a broad variety of securities products in addition to variable contracts, there are a number of jurisdictions where you are not going to be able to sign them up. There are state security law prohibitions. I do not see a lot of change here, simply because it is an old issue.