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VARIABLE LIFE INSURANCE IN CANADA AND THE UNITED STATES

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MR. DAVID W. ALLEN:

Regulation of Variable Life

In 1961, the Canadian and British Insurance Companies Act was amended so that an insurance company could issue contracts with benefits dependent on the market value of a separate or segregated group of assets. Such assets are distinct from the general assets of the company.

With the subsequent introduction of variable contracts backed by these segregated assets, the provincial securities commissions questioned whether such contracts were "securities." In 1969, Ontario decided that they were securities, thereby necessitating the filing of prospectuses and registering agents as securities dealers.

After industry representations were made, supported by the Superintendent of Insurance, the Ontario Securities Commission ruled that a debt obligation guaranteed by an insurer was exempt. The Commission then concluded that an individual life insurance contract guaranteeing

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the payment at maturity of an amount not less than 75 percent of the premiums paid up to age 75 was a debt obligation.

The need for some form of regulation was recognized by the provincial Superintendents of Insurance, and they drafted guidelines governing variable contracts of life insurers; these guidelines were mainly concerned with disclosure. The Superintendents then asked the trade association, the Canadian Life and Health Insurance Association (CLHIA), to establish a review procedure. It did so and issued interpretations of the guidelines. The Superintendents' guidelines do not have the force of law, but some provinces, such as Ontario, have incorporated some or all of them into their Insurance Acts.

The filing procedure through the CLHIA is relatively straightforward. Like anything, the elapsed time depends on familiarity with the process. The only complication in the process is that some provinces have slightly different requirements. Some require preapproval before use, whereas others give you deemed approval if no objection; some require that the material to be reviewed should include sales and promotional material. It is not necessary to go through the CLHIA. On one particular product, we found it easier to deal with the provinces individually.

While a prospectus is not required, there is an Information Folder which takes its place. You have to file a new folder annually or whenever there is a material change in facts. This folder must be delivered to a prospective purchaser and a signature of acknowledgement received before an application is signed. The Information Folder contains the type of information that an individual needs in order to be fully informed of what he is buying. This includes, for example, the investment objectives of the fund, the charges, its tax status, and the management fees.

Investments

Investments in the segregated funds are made in accordance with the provisions of the Canadian and British Insurance Companies Act, with the segregated funds being treated as a subset of the general funds.

The Guidelines of the Association of the Superintendents for variable contracts impose further limitations either directly or through increased disclosure.

You can have a wide variety of funds. At my company, we offer these:

1. Equity Funds--long-range growth objectives

2. Diversified Funds--composed of bonds, stocks, mortgages, real estate--again looking at long-range growth

   It is desirable to limit the amount of real estate and mortgages to 15 percent of the assets in any fund. This avoids having to disclose in the Information Folder an analysis of these assets and having to comply with rules pertaining to valuation methodology.

If you choose to go over 15 percent, once you hit 30 percent, you have to establish minimum cash positions; in any case, you cannot go above 50 percent. This effectively precludes the use of a separate real estate fund for variable life.

3. Short Term Securities Funds--maximizing short-range returns

4. Bond Funds

5. Indexed Security Investment Plan (ISIP) Growth Funds

   An ISIP is a curiosity of Canada. We set up an ISIP fund at the beginning of 1984 in response to a new federal tax law that basically reduced the amount of capital gains subject to tax by the inflation component, in return for annual taxation of part of the unrealized capital gains (capital gains are normally only taxed as realized). Many held out great promise for the product, but the industry sales, (primarily through a few brokers) were very poor, and the ISIP was effectively killed in the current budget. It was replaced by a lifetime capital gains exemption of $500,000, and this will have some interesting effects on variable life.

Policyholder Taxation

Traditional whole life policies are exempt from tax on the inside buildup until such time as the policies are surrendered. In contrast, variable life policies are taxed annually on the investment earnings. This places variable life at a competitive disadvantage in which the purpose of the purchase is to fund life insurance.

The source of earnings is important. Investment income (interest and dividends) from all sources in excess of $1,000 is subject to income tax each year. In Canada, dividends from taxable Canadian corporations receive favorable tax treatment with the objective of eliminating double taxation (once at the company level and once at the investor level).

Taxable (i.e., realized) capital gains are allocated to each policyholder each year. On disposition (and this includes moving from one fund to another) all unrealized capital gains are also allocated. Fifty percent of the gains are subject to tax.

For a person in a 50 percent tax bracket whose investment gains are made up of 70 percent capital gains, 10 percent dividends from Canadian corporations, and 20 interest, the favorable tax treatment reduces the rate from 50 to 30 percent with the proposed new budget. With the capital gains exemption, the effective tax rate then becomes 12.5 percent.

Registration

The exception to these tax rules occurs when a policy is registered as a Registered Retirement Savings Plan (RRSP). There the savings premiums are tax deductible as paid, and all proceeds are fully taxed when realized.

Two out of every three of our variable life policies are registered. However, we see this as a problem in that there are many situations in which there can be complications down the road. The first two problems are common to any fixed-premium permanent plan being registered and explain why most companies no longer allow permanent insurance to be registered. First, the amount of deduction available for an RRSP is subject to a dollar maximum. If an individual has a pension plan where his contributions are a function of salary, then if his salary rises by too much, there may not be any tax deductions available in the future for the insurance premiums. Second, the deduction is earnings related so that if the individual is disabled, he may not be able to use the full deduction. The third reason is that anyone with significant amounts of savings should register fixed-income securities in preference to equities, because like the stock market, yields available on dividends and capital gains are already discounted to some degree by the favorable tax treatment given to an ordinary investor. That is what the investment texts say; in fact, there are no studies available in Canada to prove whether or not that is true.

On the marketing side, we introduced our variable life product in 1970. In 1975, the Canadian stock market crash resulted in the bottom dropping out of the industry sales. Along with other companies that had variable life plans, we experienced policyholder withdrawals and policyholder confusion at getting less than they had put in. The insurance industry was, after all, still noted for its guarantees. Most companies chose to withdraw their products at that time.

A few remained, and their policyholders experienced the strong run-up in the stock market. But, aside from us, the last company withdrew in 1982 due to continuing low sales. It seemed that while poor stock market performance hurt, good performance was not a guarantee of success.

We neglected our product until the fall of 1983 and then faced the difficult decision of what to do. A common reaction, at least in Canada, would be to reprice--to lower the cost to make the product more attractive. We did decide to reprice, but we made it more expensive. We used this extra money to develop the multiple funds, with switching and a dump-in facility which lets people put extra amounts within their policy at any particular time. More importantly, we did some fancy marketing. Our sales doubled and are still increasing at a strong pace.

We have five products with maturity dates of 20 years, ages 60, 65, 71, and 99. (Age 71 is included because RRSPs must be annuitized by that time.) Each product has a fixed premium which must be paid, though the policy can "pop," which is the vanishing premium or premium offset concept. The face amount of the policy equals the number of years between issue and the maturity date, times the fixed premium.

The fixed premium is made up of three fixed components--the policy fee, the fund premium, and the insurance/expense premium. The death benefit is the face amount plus any excess of the fund value over the fund premiums paid in. As a result, investment earnings do not serve to increase the amount at risk. This stays predefined. The maturity

value is the face amount or the fund value, whichever is higher. Note that this is above the 75 percent required by the guidelines. Additional payments (the dump-ins) can be made at any time. They enter the death benefit and maturity benefit calculations, but only at the 75 percent guarantee level. There are no minimums or guarantees on surrender, and there are early withdrawal penalties. At death, surrender, or maturity, the annuity options available include both fixed and variable payout annuities.

Psychological Profile

Generally, variable products appeal to individuals with an investment orientation--in response to this, our product is called the Investor. Such individuals understand the potential for growth by investing in the market and are prepared to take some risk for a greater investment return potential. At the same time, this client wants some security, either for financial or psychological reasons, and this is provided through professional fund managers and through maturity guarantees.

The clients of today are better educated, and this knowledge leads them away from traditional products to ones with special appeal. The flexibility of dump-ins and riders has appeal--as does being able to participate in the investment process through the fund switching facility.

In the juvenile market, most typical juvenile variable insurance policies in Canada (the ones that are still being sold) are nonexempt, which means that there is annual tax reporting on the inside buildup. This has eliminated the previous objections to the annual taxation of variable life and has now made it more attractive.

In the systematic savings market, the market consists of the young singles and the two-income families who require a systematic savings program. The Investor is a savings plan with completion insurance--insured savings, in other words. This, by the way, avoids its perception of being a life insurance contract that is in competition with traditional permanent policies which are taxed only on disposition. The Investor to 99 appeals to baby boomers due to their untraditional approach to life while it meets their need for insurance with investment growth. Notice how the emphasis on insurance is greater here than it is with the other products.

The retirement income market is the RRSP market. For the other two markets, the one-income families and the professionals, we have slightly different sales approaches. Our sales are not skewed upscale. We seem to be covering a cross-section of the Canadian market through a cross-section of our agents.

Future

Most companies in Canada are considering variable life, but not seriously. Almost all are looking at variable universal life but are deterred by poor sales experience in the U.S. and the lack of demand pressure from agents. There is also uncertainty on tax status. Within limits, universal life policies are taxed only on disposition. With the presence of a

segregated fund and its separate taxation, will the whole policy perhaps be taxed annually as a result?

We see our rates of sales increases declining as we reach saturation. In effect, we have been limited by the size of our field force. A standard marketing book would say that since the Investor is unique, the whole market is there for the taking, but you have to be able to access it. Our product is too unique (since it is the only one), and even though we have a separate brokerage operation, there is a lack of trust by brokers about the whole concept. They cannot be easily motivated, if at all, to learn a concept that is so alien to their normal selling methods. It is probably not helped by the fact that we charge our managers and our brokers for the sales material as it is too expensive to give away. While it cannot be proven, we feel that the quality of the presentation materials and the impression those materials transfer to what is an intangible are key ingredients to success.

The new budget proposes a lifetime capital gains exemption of $500,000. This should serve to increase the need and the receptiveness for variable life as people become aware of this tax change, but they are not going to rush out and line up in brokerage offices.

The barriers to entry for companies are higher than they used to be. Those companies which are now selling universal life will probably not be successful in persuading their agents to go back to a nonflexible fixed-premium variable life (especially as that same agent has probably read that variable universal life or some other modification is the wave of the future). The systems costs necessary to support variable universal life are quite staggering, which is not to suggest that the cost of even supporting variable life with a fund switching facility is at all trivial; it is very expensive. I am not even sure that if we had to start over from scratch, rather than building over time, we could justify it from the sales of a new product. My personal view is that the risk of failure is too high to justify it yet. In fact, I have strong reservations about it ever being viable in Canada when you consider the potential market size against the development cost.

We introduced variable life in the U.S. in mid-June of 1984, and sales since then have been exceedingly modest. The reasons for this seem to be less with the product than with agent motivation due to the difficulty of persuading an agent who is comfortable with universal life to sell a fixed-premium nontraditional product and to take the time to learn it when he knows that new changes are coming on the horizon.

MR. STEPHEN E. ROTH: This is an update on the U.S. regulatory status, both at the state level and at the Securities and Exchange Commission (SEC), to discuss the current status of the companies' filings that have been made at the SEC, and to address on the prospects for future product approvals in the U.S. market in the months ahead.

Looking at state regulations first, in December 1982 the National Association of Insurance Commissioners (NAIC) amended the model variable life insurance regulation that had been first adopted in 1973 and

amended as recently as 1979. In that 1973 regulation, there were significant constraints on product design, most of which were inserted into the state insurance regulation in an attempt to convince the SEC that SEC regulation of the product was unnecessary. There were a number of requirements in the old model regulation. Lifetime coverage was mandated. The product had to provide for the payment of level premiums; therefore, no term policies were permitted. The contract had to provide for a minimum death benefit guarantee at least equal to the initial face amount. Minimum premium multiples and maximum premium rates based on the issue age of the insured were specified; those rates being designed in order to limit the investment features of the product.

The death benefit under the old regulation had to vary with separate account investment experience, and in fact, two death benefit designs were specified: those have come to be known as the Equitable design and the New York Life design. There were restrictions on what the separate account could invest in; real estate, commodities, and other exotic types of investments were prohibited. Finally, limits were placed on the charges that could be assessed against the separate account funding the contract. Specifically, the so-called mortality and expense risk charge was limited to 50 basis points, and the fee for investment management services was limited to 75 basis points and required to decline as assets grew.

The 1982 amendment removed all of these requirements, by and large, so that companies were permitted to exercise greater flexibility in designing products. The regulation deleted those provisions believed unnecessary from a state insurance law perspective since it was assumed that the product was going to be subject to SEC regulation. It was not necessary, for example, to limit the investment features of the product. Today the 1982 amendment has been adopted in fifteen states.

It might be helpful in order to assess the regulatory climate at the state level to mention those jurisdictions that still have the old model regulation in effect. Most of the major jurisdictions do have the old model regulation. California is in the process of considering the 1982 changes and has been seeking informal comments on a proposed draft regulation that it has been circulating. It is anticipated that California will commence formal adoption procedures in September or October of 1985. New York has been studying changes, although to my knowledge, no formal proposals have been forthcoming.

That leaves about 24 jurisdictions that have no variable life regulation at all. The American Council of Life Insurance (ACLI) is seeking to have the amended 1982 model adopted only in those jurisdictions where domestic company interest has been expressed in issuing the product. In fact, some of the 15 jurisdictions that have passed the regulation fell into that category. While 24 jurisdictions currently have no regulation, it is probably noteworthy that this has not deterred variable life writers from selling in those jurisdictions because product approvals have not been difficult to obtain there.

It might be instructive to note the progress in obtaining state approvals for the variable universal life products of Prudential, Acacia, and Life

of Virginia--the three companies that are currently in the market with the product. Prudential has obtained regulatory approval in about 45 jurisdictions for its product. Part of that is because of the product's particular design features. It has a minimum death benefit guarantee, and it has scheduled premiums, although it also provides for premium flexibility. That may have been important in getting product approvals in some of those jurisdictions.

Acacia has obtained product approvals in about 25 jurisdictions, and Life of Virginia is also pursuing product approvals in a number of jurisdictions. In Acacia's case, a number of its approvals are based on the clause in the old model regulation that allows the Commissioner the discretion to approve products that are at least as beneficial to policyholders as the design mandated by the regulation.

When the NAIC adopted the 1982 amendments, it instructed that guidelines be developed in three areas not specifically covered in the regulation, the first being standards for minimum nonforfeiture values. The second guideline is to set forth limitations on separate account investments. In the old regulation, there were certain prohibited investments. Those prohibitions were removed and replaced by a general standard that the separate account assets must be sufficiently liquid to meet anticipated withdrawals. This second guideline will attempt to articulate just what that standard means.

A third guideline is being developed dealing with sales illustrations for the new products. As far as illustrations are concerned, what the states do may be less relevant than what the SEC does since the SEC places limits on illustrations. The most important limit is that it restricts illustrations to a gross assumed investment rate of return of 12 percent. The ACLI has committees looking at all three of these areas.

Let's now turn to SEC regulation. In the U.S., the Investment Company Act places limitations on the charges that can be deducted in connection with periodic payment plan certificates. Limits are placed on the sales loads and administrative charges that can be deducted. The sales load limits are specific numerical limits that are defined as a percentage of actual payments. The limit on administrative charges generally is one of reasonableness. There are no numerical limits specified, and generally no anticipated element of profit can be included in administrative charges. There are no regulations in the investment company act itself for insurance charges, although the SEC has been exercising its jurisdiction rather aggressively over insurance charges.

The industry has assumed all along that variable universal life is an Investment Company Act security and that it would be subject to limits on sales loads and on other charges unless exemptions were provided. With that in mind, about two and a half years ago, the industry began to develop a position on exemptions that are necessary from the investment company act limitations. In June of 1983, the ACLI filed a petition for rule making with the SEC urging the SEC to adopt an exemptive rule of general applicability that would provide some relief from these limits on charges.

After a comment period, the SEC promulgated the temporary exemptive rule, Rule 6e-3(T), which actually came into effect in December 1984. That rule is now in effect, has the force of law, and can be relied upon by a company now filing with the SEC. At the same time that the rule was published, the SEC sought comments on the temporary rule. A number of changes had been made to the original ACLI petition. The comment period closed at the end of March 1985, and the SEC is now evaluating the comments filed.

In connection with seeking comments and the prospect of adopting a final rule, the SEC indicated that companies now filing and getting processed through the SEC will have a one-year transition period, after a final rule is adopted, to conform their product to any changes that might be made in the final rule as compared with the temporary rule.

About a dozen comment letters were filed on 6e-3(T). The two most important comment letters were those filed by the ACLI and the Prudential. I will summarize the provisions of 6e-3(T), the modifications that the ACLI comment letter is seeking and then separately address the Prudential letter.

Basically, rule 6e-3(T) provides that the sales load deducted under a variable universal life contract is permissible so long as it can be shown that it meets certain limits, if so-called guideline annual premiums are paid under the product.

What is the definition of sales load, and what is the definition of guideline annual premium? Rule 6e-3(T) defines sales load generally as being the charges remaining after all other charges set forth in a list have been subtracted. In order to be subtracted, a company must meet one of the applicable standards for these other charges. For example, administrative charges are deemed to be administrative charges if they are within the range of industry practice and include no anticipated element of profit. One of the most important deductions in determining sales load is cost of insurance. The rule specifies that cost of insurance shall be based on the 1980 CSO table and an assumed interest rate of 5 percent. Therefore, any cost of insurance charge for a standard rated policy that is based on the 1958 table or other higher rates would be deemed to be a sales load to the extent of the excess over 1980 CSO rates. That excess would have to be factored in when determining whether the product complied with the sales load limitations.

The rule then defines guideline premiums. Basically, they are the level annual premiums required to mature the policy, based on 1980 CSO cost of insurance rates, a 5 percent rate assumption, and the actual charges deducted under the policy.

In its comment letter, the ACLI addressed both the definition of sales loads and the definition of guideline premiums. It urged that a change be made to assume 1958 CSO cost of insurance rather than 1980 CSO. Alternatively, it sought clarification of the deduction for cost of insurance. There is a deduction provided for substandard risk charges. If an extra deduction is made for substandard risk, that deduction is not deemed to be a sales load. Clarifications were sought to allow extra

charges if simplified underwriting is used. Comments were made about the fact that there are different 1980 tables, which we do not believe the SEC was aware of when it promulgated the rule. The ACLI simply wanted a clarification that any permissible 1980 table should be allowed, so long as it was being used on a consistent nonbiased basis.

As to guideline premiums, just as 1958 CSO was specified in the petition and is being sought for use as cost of insurance in determining sales loads, the same assumption is being sought for use in determining guideline premiums. Put another way, the industry is seeking to increase the guideline premium assumption that can be used in showing sales-load compliance.

Having defined sales loads and guideline premiums, what are the limits on sales loads? The first limit is that the sales load made in the first year, deducted from actual payments, cannot exceed one-half of the actual payments made. That is an absolute maximum limitation.

Second, the sales loads deducted over time cannot increase as a percentage of actual payments. Guideline premiums come into play with respect to the so-called 9 percent rule contained in the Investment Company Act. Basically, 6e-3(T) provides that the company does not need to strictly comply with the actual 9 percent of payments limitation in the statute, provided that the company can show prospectively, when it files a product with the SEC, that the average sales load charged will not exceed 9 percent when guideline premiums are paid for the lesser of 20 years or the life expectancy of the insured. Therefore, in demonstrating compliance with the 9 percent test, the company simply needs to assume that guideline premiums are paid. To the extent more than 20 guideline premiums are paid, additional sales loads can be deducted, but they must comply with the nonincrease rule mentioned previously.

Another provision of the rule deals with refunds. Although half of the first year's payments can be deducted as sales loads, those payments are subject to a refund requirement. Basically, Rule 6e-3(T) provides that a company must refund an amount of sales load upon surrender of the contract within the first two years after issue. The amount refundable is the excess sales load over the lesser of 30 percent of guideline premium or 30 percent of actual premiums plus, if the contract is surrendered in the second year, the lesser of 10 percent of the guideline annual premium or 10 percent of actual premiums paid in the second year. To the extent premiums are paid in either year in excess of a guideline premium, the company is allowed to retain 9 percent of those excess payments as a sales load and is required to refund any amount over 9 percent.

The ACLI comment letter addressed two problems with this method of requiring refunds. The first problem is that the amount refundable depends on the timing of premiums paid. If less than the guideline is paid in year one, the company would be forever precluded from charging 30 percent of the remainder of that guideline in the second year, without refund exposure, even though it might actually be paid in during the second year. Similarly, if more than the guideline premium was paid in the first year, the refund requirement would be based on

the excess over 9 percent of that extra premium; whereas if that extra premium were paid the first day of the second year, the company would be allowed to deduct 10 percent without refund experience. The ACLI letter seeks to clarify this timing problem.

In the ACLI comment letter, the amount sought to be retained is 50 percent of the actual payments or 30 percent of the guideline, whichever is less.

What about back-end loads? Until now, the SEC has not permitted back-end loads in an exemptive rule. Rule 6e-3(T) permits any kind of sales load, whether it be front-end, back-end, or deducted from cash value as a part of the monthly processing. However, under the rule, back-end loads are subject to the same dollar limits that would be applicable to front-end loads. The dollar limits applicable to front-end loads are the ones that I have just summarized. In determining whether or not these limits are met, however, guideline premiums can be assumed. The ACLI has sought in its letter to liberalize the relief for back-end loads in order to incorporate what was originally contained in the industry petition and denominated the "Economic Value Test." That test would allow insurers to retain excess investment earnings on back-end loads, essentially compensating them for the time value of money. The other comment on back-end loads in the ACLI letter is to seek clarification of how the nonincrease rule would apply to complicated back-end load and combination front-end and back-end load designs. It should not have much applicability in those situations.

In addition to back-end loads, Rule 6e-3(T) specifies the amounts of sales load that can be deducted in connection with adjustments in insurance benefits. The statute itself would not permit additional sales load to be deducted in connection with insurance benefit increases; rule 6e-3(T) does. However, the statute does require that free look, conversion, and refund rights be provided to policyholders after an increase. The only way to avoid those requirements is to limit the additional sales load deducted in connection with an increase to 50 percent of the sales load that would otherwise be allowed. This is somewhat complicated and technical, but it is not clearly stated in the rule. The ACLI comment letter seeks to avoid the application of the free look, conversion, and refund rights to increases and to attempt to clarify what some of these provisions in the rule mean. Most importantly, with respect to the 50 percent trigger, the ACLI comment letter recommends that instead of limiting the sales load to 50 percent, companies should be exempted from any refund requirements, provided that the additional sales load deducted upon an increase does not exceed 30 percent of the first year's guideline premium and 10 percent of the second year's guideline premium.

Certain rules are also specified in the comment letter relating to how companies should effectuate conversions to fixed-benefits contracts, when the contract does not meet the trigger.

The Prudential comment letter was also filed in March. Prudential had not filed any written comments on the original industry petition, so this is its first written submission. This letter took a very different

approach, and in fact, I think I can fairly state that Prudential has taken serious issue with the basic regulatory framework I have just outlined. In particular, Prudential argues that guideline premiums are an inappropriate basis on which to measure sales load. Instead, it suggests that sales load should be based on a target premium concept, defining that to be the premium reasonably expected to be paid on each contract that is issued. The target premium would differ from one insured to the other, although the insured might be in the same risk class and otherwise have the same characteristics.

In addition, the Prudential letter focuses on the 50 percent rule for refunds and argues strongly that companies ought to be able to retain one-half of the first year's premiums without refund if the contract is surrendered. However, in exchange for that, their proposal suggests that there be a true-up provision, applicable to variable universal life contracts, requiring that at the end of the lesser of four years or at the time the sales load levels off (let's say it began at 30 percent and went down to 7 percent in year two), the company should look at the actual premiums paid, and even though the policy is still in effect, give back to the policyholder the excess over 50 percent and 10 percent. Unlike rule 6e-3(T) and unlike the ACLI approach, the Prudential approach would require that premiums be paid in connection with increases in insurance benefits in order to deduct sales loads. It would not permit sales loads to be assessed against cash value upon adjustments in insurance benefits. It would require that premiums be paid.

One important area of 6e-3(T) relates to the mortality and expense risk charge that used to be limited in the state model regulation to 50 basis points. Rule 6e-3(T) requires that the charge either be within the range of industry practice or that it be demonstrated that the charge is reasonable in relation to the mortality and expense risks assumed. So far, industry practice is 50 to 60 basis points for variable life, so that does not offer a lot of flexibility, at least presently. As to what is reasonable in relation to the risks assumed, that is an unknown. It will be up to companies on a case-by-case basis to demonstrate that charges more than 60 basis points are reasonable in relation to the risks assumed. The products that have been approved so far have not exceeded 60 basis points, so it is a little early to tell how flexible the SEC is going to be on that.

There are about 19 filings that have been made--19 products filed by about 15 companies. Only three have been declared effective--Acacia, Prudential, and Life of Virginia. Acacia and Prudential were actually declared effective in October of 1984, before 6e-3(T) was promulgated. Acacia did not need the relief in 6e-3(T) since its sales load was limited to 7 percent of actual payments, so it never exceeded 9 percent, and no guideline premium assumption was necessary.

The theory for the Prudential product approval was that it had a scheduled premium feature to it and had a minimum death benefit guarantee like the more traditional scheduled premium variable life products; therefore, the staff was comfortable in processing the filing under 6e-2--the existing rule for scheduled premium variable life.

Only Life of Virginia has obtained product approval since Rule 6e-3(T) has been on the books as of December. Life of Virginia took 11 months to get its product declared effective. I think that was an anomaly due to the timing of 6e-3(T).

A number of the products that are pending could be viewed as low-loaded products--like Acacia's. For example, the Keystone Providence, USAA, and Volunteer State products have sales loads less than 9 percent at all durations.

What are the prospects for the other pending filings? What if a company were to make a filing today, how long would that take to get processed? What are the stumbling blocks? It seems very likely that these other low-loaded products are going to be declared effective within the next few weeks. Volunteer State filed an individual application on a few minor points, and it is expected that it will be declared effective shortly. USAA Life should follow shortly thereafter.

The time frame for other products is a bit of an unknown at this point. It is just not clear how long those products relying on the guideline premium test are going to take to be approved. I think it is going to be slow. Usually it takes about four to six months to get a product through the SEC, from the time of filing until it is declared effective. I think the Life of Virginia experience of 11 months is definitely on the long side, but those guideline premium products are going to be facing a number of technical questions from the staff that may not be capable of easy resolution.

One reason that these questions are forthcoming is that the staff now interpreting and implementing 6e-3(T) is new. We have had a staff turnover since Rule 6e-3(T) was promulgated. The people who are now running the office have not had a great deal of insurance experience, so we are in the process of working through a lot of what had been worked through over the last couple of years with the previous staff.

As far as the final rule is concerned, I do not expect to see a final rule until before the fourth quarter of this year. The Prudential comment letter may have had an effect on the time period for a final rule. It is likely that the staff will at least take a hard look at rethinking some of the principles in Rule 6e-3(T) in that framework before it prepares the final rule.

I have not talked about Rule 6e-2, except in passing. It is the existing rule for scheduled premium variable life. Rule 6e-3(T) applies to flexible premium products defined as products which do not fix the timing and amounts of premiums except in the first two policy years, while Rule 6e-2, the other exemptive rule, applies generally to scheduled premium products. The staff has proposed some changes to Rule 6e-2 to conform it to Rule 6e-3(T). One of the issues that is going to be addressed by the commentators, and by the staff for that matter, is whether or not they are going to try to blanket the market with exemptive rules, if you will, so that any product filed, regardless of how flexible the premiums are, will fall either into one rule or the other. The more conservative approach would be to define 6e-3(T) to apply to

truly flexible products and 6e-2 to apply to truly scheduled products and leave somewhat undefined products in the middle. That would require companies with those kinds of products, to choose a rule first of all, and obtain the individual exemption applications necessary to process their product.

MR. MICHAEL R. TUOHY: Mr. Roth has outlined all the horrific regulations you have to go through to get this product up and going. One question a company must ask is if after going through all that, is the product going to sell? The experience with fixed-premium variable life is pretty spotty. There are some success stories; Equitable sold a lot of business (not so much recently); John Hancock continues to sell a lot of business; and the Prudential has had pretty good success with its fixed-premium variable life product. But as Mr. Allen mentioned, his company is not selling much of its fixed-premium product, and there are a lot of companies in which the fixed-premium version of this product has not taken off at all and has been an expensive exercise for them.

Variable universal life does not have a track record. As Mr. Roth showed you, there are three companies that now have approval. Acacia was the first, but it has not attacked the market greatly. Life of Virginia only recently has received approval. The only real indication of the attractiveness of this product is what is happening at the Prudential. The Prudential, although it received approval in the fall of 1984, did not launch its product fully to its sales force until late February 1985. Since then, Prudential has met with enormous success. If you look at production of permanent business, size $25,000 and greater (the minimum size for its product is $25,000), then for those agents who can sell the product, it is already the most popular. In fact, for those agents who can sell both their fixed-premium variable and their variable universal, more than 50 percent of their production of permanent business above $25,000 now is variable. So, although fixed-premium variable life was spotty, the only real test we have got so far is that variable universal life is very sellable.

If variable universal life is sellable, can you make any money out of it? This is a question that a lot of companies are asking. I have run some tests of both the Prudential product and two products that appear to comply with 6e-3(T), first a front-loaded one and then a back-loaded one. The approach was to take a set of assumptions and solve for how much up-front room is available to pay a salesman. In other words, we selected various profit objectives and came up with a number that would be available to use as sales expenses, including commissions.

Let's have a look at the Prudential product. I must remind you these are not Prudential's pricing assumptions; these are some pricing assumptions that we threw in, just to play this game. Look at a couple of males, issue ages 35 and 55, smoker and nonsmoker. The premium rates and policy values were taken from Prudential's prospectus. For lapse assumptions, we assumed that for the 35 year old, lapse is 20 percent in year one, graded down to 5 percent in the sixth year, and for the 55 year old, 15 percent in year one, graded down to 5 percent in the sixth year.

The mortality assumptions as a percentage of the 1965-70 Select and Ultimate Table is 55 percent for nonsmoker, 110 percent for the age 35 smoker, and 90 percent for the age 55 smoker. Acquisition administrative expenses were assumed to be $3/1,000. Maintenance administrative expenses were assumed to equal the loads in the product for these expenses. Renewal commissions were 10 percent for years 2, 3, and 4; 3 percent for years 5-10; and 2 percent for years 11 on.

The product has a .40 percent investment advisory fee. We assumed that .15 percent of that is profit. We also assumed that the charge for the guaranteed minimum death benefit is all profit. That is a fairly aggressive assumption, but the results are not affected greatly by it. We took an annual premium mode and ran the 35 year old for 30 years and the 55 year old for 20 years with an average policy size of $50,000.

What came out of this exercise? We looked at it on three profit objectives--one just to get a 12 percent return on investment (ROI), one to get a 15 percent ROI, and one to get a 5 percent profit margin (PM), that is, a five percent annual average profit using a discount rate of 12 percent. The results are summarized in Table 1. The numbers are reasonably consistent. For example, if your objective is a 12 percent ROI, you have a range of 120-35 percent to spend on acquiring the business. If you are looking for a 5 percent average annual profit, then you are down closer to 100 percent.

TABLE 1

Margins for Acquisition Percent of Premium Expenses

		12% ROI	15% ROI	5% ROI
35	Nonsmoker	120%	107%	95%
	Smoker	134	122	108
55	Nonsmoker	125	114	99
	Smoker	131	121	105

The margins for acquisition costs in this product may be within the range of tolerance, especially if you were a bit more aggressive in your assumptions or if you can get them up a bit. So maybe you could distribute this product through a traditional distribution system and make some money out of it. If you analyze the profitability of this product by source, you will find that most of the profit is mortality. Prudential's guaranteed maximum cost of insurance rates for nonsmokers are not nonsmoker 1980 CSO but aggregate 1980 CSO. A surcharge is added on for smokers.

That is the story on Prudential's product. We then had a look at a product that would comply, as far as we could tell, with Rule 6e-3(T). First, we looked at a front-end loaded product using those two same males, and the target premiums were $10/1,000 for age 35 and $30/1,000 for age 55. Cost of the insurance rates was equal to the 1980 CSO smoker/nonsmoker rates. Front-end sales loads were assessed on target premiums--30 percent for year 1, 10 percent for year 2, 7 percent

thereafter. Premium tax was assumed to be 2.5 percent, and administration expense was assumed to be $3/1,000 plus $40 per annum; these expenses were offset by identical policy charges. The investment advisory fee was .50 percent. (We regarded .25 percent as profit.) The mortality and expense risk charge was .60 percent. (We regarded all of that as profit.) We assumed that the separate account earned a gross rate of 12 percent.

The assumptions used for mortality and lapse were the same as the ones for the Prudential product. We assumed that there was a renewal commission of 5 percent payable from year 2 on.

How much do we have to pay the salesman on this one? Table 2 shows that there is substantial variation by age and risk class. The numbers, if anything slightly superior to Prudential's, give a lot of room at most cells and a ludicrous amount for the 55 year old smoker. You probably would find that was so uncompetitive that you would have to cut back on it. Clearly, it gives you a chance to pay a typical life insurance commission on this product at the higher ages, assuming you designed it with the maximum possible front-end sales loads.

TABLE 2

6e-3(T) Margins--Front-Load Product

		15% ROI	5% PM
35	Nonsmoker	107%	100%
	Smoker	132	128
55	Nonsmoker	142	135
	Smoker	236	243

The results are not too bad for our front-end loaded product. We did exactly the same things except we converted some of those front-end loads into back-end loads. Basically, the sales loads were all made back-ended, and the $3/1,000 initial administration charge also was back-ended. We maximized the back-end load through 5 years and graded it off to zero at the end of year 15. Table 3 shows the margins are substantially smaller. You are looking at about a 50 percentage point cut in what you could afford to spend up-front on that product--not very good news.

TABLE 3

6e-3(T) Margins--Back-Load Product

		15% ROI	5% PM
35	Nonsmoker	61%	45%
	Smoker	84	71
55	Nonsmoker	97	81
	Smoker	179	187

Maybe we can jiggle a bit with our cost of insurance rates. Possibly you could charge substantial extras for smokers. What if you upped the nonsmokers to 1980 CSO aggregate? Well, you are going to increase margins by about 30 percent of premium on that basis, and if you could squeeze all the way to 1958 CSO, then you would gain an additional 20 percent. The results in Table 4 show that the 1958 CSO does bring you up into the 110 percent range, as far as margin availability is concerned.

TABLE 4

Effect of Different COI Charges

6e-3(T) Margins--Back-Load Product--Age 35 Nonsmoker

COI	15% ROI	5% PM
1980 CSO--Nonsmoker	61%	45%
1980 CSO--Aggregate	89	79
1958 CSO	111	107

This whole business of 6e-3(T) product profitability is being discussed everywhere. Compared to a nonvariable universal life, your margins are getting squeezed. You have limits on your cost of insurance rates. You have limits on your back-end loads, and you just have 60 basis points interest spread (so far) from your mortality and expense risk charge. Let's compare the sort of margins you have on a front-end loaded variable universal life versus a universal life that you may have priced a year or so ago. There are only a few low interest spreads out there. (Most people are earning a low spread but priced a much higher one.) The spread that you are going to have on a variable universal life is pretty much likely to be less than your universal life. You have the 60 basis points mortality and expense risk charge. You might make a bit out of your investment advisory fee, but you might just be dealing with a total 85 basis points compared to a universal life spread on the order of 175 to 200 basis points.

The front-end loads that you can charge under 6e-3(T) are pretty similar to what have been charged on front-loaded universal life, so you have to make up the interest spread deficit in your cost of insurance rates, and perhaps there is enough room there. The cost of insurance rates on universal life are pretty low. If you fatten them up to 1980 CSO, you can probably make it on the front-loaded product, but the big query is on the back-end product. Can we afford the typical front-end expenses involved in distributing the product through a traditional distribution system? You have a lower interest spread, you probably have lower surrender charges than the typical back-end loaded universal life because of restrictions on sales loads, and so can you make up the difference in the cost of insurance rates? Probably not.

There are a lot of companies looking at this product and wondering what to do, which way to go. I think those companies have five different options facing them.

First, they can take the route of Acacia and Life of Virginia and go for a low-load product. Second, they could design a product similar to Prudential's. Third, they could try to design something that complies with 6e-3(T). Fourth, they could sit around and fester for a while and wait for 6e-3 to come along. Or, they could look again at 6e-2. The rules likely to be changed under 6e-2 enable one to design a much more attractive product in my opinion.

Let's look at the pros and cons of each of those five alternatives. I have looked at them in five contexts.

1. Can you afford to pay a traditional life insurance commission?

2. Are the systems available to handle the product?

3. Could you get the product up in a timely fashion?

4. Once you have it up, is the product likely to have a reasonable life span?

5. Is the product sufficiently flexible?

My conclusions are summarized in Table 5. The low-load product clearly does not satisfy the commission requirement. You cannot squeeze enough margin out of this product to pay a traditional life insurance commission. It may be fine if you are aiming at the stock broker or the fee-for-services market, but this product is not going to sell too well under a traditional agency system. Probably some systems will be up to handle this product by the end of the year, so the systems may be satisfactory. The SEC is approving products of this type, so you should be able to get the SEC approval within a reasonable time span.

TABLE 5

Choice of Product Design

	Commission	Systems	Timing	Product Life	Flexibility
Low Load		X	X	X	X
Prudential	X			?	?
6e-3(T)	?	X	X	?	X
6e-3	?	X		X	X
6e-2(Revised)	X	X	?	?	

The product will probably be around for some time, given proper tax treatment. There will be a continuous market, I believe, with the stockbrokers, the fee-for-services people, and the genuine financial planners, so there is a reasonable product life. Clearly, the product is flexible. The only problem is that you cannot pay a traditional commission.

The Prudential product can pay the commission; however, it fails on most of the other items. As far as I am aware, there is no systems house developing a system to handle the Prudential product. The Prudential is very pleased with itself; it developed its own system in-house within twelve months. The Prudential is the Prudential, and how many man years of effort it threw at that particular activity I am not sure. I doubt if many other companies could get together a team as hefty as the Prudential's and get a system up internally in twelve months time. So the only system in town is the Prudential's, and the Prudential is not going to let you borrow it.

Clearly, that puts the timing in question. I would question the product life of the Prudential product in that it is not entirely flexible. It may be seen as a half-way house product, and if variable universal life does take off, maybe Prudential will have to increase the product's flexibility.

The third option is 6e-3(T) with the question of whether you can afford to pay a traditional life insurance commission. You might be able to if you are front-end loaded but then that product might not stack up as well against the back-end loaded universal life that you are currently selling.

There probably will be systems to handle most or at least some 6e-3(T) designs by the end of 1985. If you are developing a product, keep in close touch with your software house because they have restrictions on what products they can handle. Assuming the systems are okay, and the timing is okay, the products relying on the guideline premium rule may still have problems with the SEC, so timing may still be a question. Product life also is a question. If 6e-3 comes rumbling along in the last quarter of 1985, then 6e-3(T) products possibly will have to be updated to handle 6e-3 changes. So, the product may not last too long, but clearly it is flexible.

The fourth alternative is 6e-3. We do not know what 6e-3 it is going to be, so we do not know if we are going to have more room to pay any commission under it. We may get a bit more fat out of 6e-3 than we would out of 6e-3(T). Probably there will be systems to handle 6e-3 when it eventually arrives, but of course the timing is completely up in the air. Mr. Roth says the earliest we can possibly hope for 6e-3 is the fourth quarter of 1985, but in fact, 6e-3 may never come, so it is not necessarily the greatest strategy to sit around and wait for it. When and if it does come, product life should be reasonable. We hope we will not see 6e-4 creeping around a year later. Clearly the product is flexible enough.

The last alternative is 6e-2 revised. The sort of products that you could design if the proposed revision to 6e-2 goes through would be equivalent to excess interest whole life with the cash value going into a separate account. You do not have to mess around with the Equitable and the New York Life methods of adjusting the face amount every year and so on. You can get a much neater, cleaner product out of it. I think you could afford life insurance type commissions.

I do not think there is a system at the moment that could handle a revised 6e-2 product, but I do not think the changes are that huge. Timing is a question. At the moment all we have is a recommended revision to 6e-2, so we have to wait for that to go through. In fact, you may be able to get a special exemption anyway before that happens. So maybe the timing as far as the SEC is not too bad, and maybe the system will be available. But again there is a question as to the product life. The product is not flexible; it is a fixed-premium product. Is the whole world going to be flexible in a couple of years, and do you then have to change all your products to a flexible nature?

So, should you go into this product? There are some companies that clearly think this is the product of the future, that it has a lot of sales appeal, and so on. There are definitely a lot of companies that would prefer the product went away and the great sales of interest-sensitive products continue into the future. But is this product going to go away? The early Prudential sales results are pretty sensational. If they continue, I think that we are going to see a lot of other companies going along with the Prudential into the product. They will feel that they have got to be there with the crowd and follow like a flock of sheep. It is essential for a company sitting on the fence to keep good track of what the Prudential is up to. If sales there continue to grow, we are going to hear more and more of this product. It will grow into a demand product from the agents, coming up in the same way universal life has.

So with that threat, you should check out what software systems are available. Do a little research as to which systems companies have the system up, where you could move, what your existing universal life software house has in the way of variable universal life, and so on. Also do some basic profit testing, not a whole product development, but find out whether, with your assumptions and your level of acquisition costs, you can get into the profitability ballpark.

You also have to decide if your product can compete with your existing universal life, even if you find that a front-end loaded 6e-3(T) product satisfies your profitability requirements, and you can pay the commission. If you have an aggressive back-end loaded universal life with high interest margins built into the product, it is going to be difficult to develop a variable universal life that looks as good as your universal life. The problem is the interest spread on variable products is disclosed; whereas the interest spread on universal life is not disclosed.

Why are companies rushing at this product? By no means is there any conclusive evidence that variable is the future savior of the industry. If you look at the names of those who have introduced fixed-premium variable life and are working hard at variable universal life, you will find that the majority is big and has captive agency forces. There are three reasons why these companies are looking at this product.

First is the movement of the asset risk from company to policyholder. Many companies had a big shock in the late 1970s and early 1980s with that sharp interest spike and cash outflow. All of the sudden, they had a major investment risk on their hands. They had a bond portfolio

that was significantly under water, unrealized capital gains ranging up to 40-45 percent at the extreme. If that cash outflow had continued, those companies would have had to realize those capital losses. With variable, you get rid of that risk--you pass it all onto the policyholder.

Second, and this may be the principle reason that several of the companies are getting into this market, is that you perhaps can recapture your sales force. If you have a captive sales force out there, how much of its business are you getting? How much of the First Colony's Universal Life or Kemper's Term Products is the sales force selling? The advantage of variable life possibly is due to licensing requirements. If agents want to sell variable life, they can only sell variable life through your broker/dealer. You can insist that if your agents are selling variable life, the only variable life product they can sell is yours. If this becomes a demand product, that could have a significant impact on the percentage of the sales that the big captive agency force companies are getting out of their captive forces.

This in return can have a significant impact on expenses. If you were to look at the impact on the large captive agency forces of, say, increasing from 60 percent of their agents' business to 70 percent because that extra 10 percent would be pure marginal business (no overhead), it could cover the additional cost you have to incur getting into this business. We could, even with this very expensive product, find that the unit expenses are down for certain companies because they are getting a much higher percentage of their sales forces' business. Also, maybe it is a sort of a big company comeback at the little company. Maybe the fact that it takes big dollars to get into this business has appeal to the big companies because they can afford it and spread it over huge amounts of volume. The little companies cannot afford it. So it is sort of a "this is a very expensive product--little company try and follow us" type of attitude. I do not know how much of that is in it.

I do not think that pure selfishness from the issuing companies' point of view is the only reason that we see this interest in this product. I think that this will end up as a consumer driven product. You might ask why the consumer gets a much better deal out of this product than he gets out of an interest-sensitive product. The expenses are greater for administering the product, and to an extent, these will have to be passed onto the consumer. Generally, the investment risk is left out when pricing a universal life product. You happily go ahead and say you are going to get 175 basis points, and you happily guarantee the policyholder that he can get his cash-value surrender at any time. Very little is put into pricing as to the inherent investment risk in the product. Basically, if you are going to minimize that investment risk, you have to stay with your investments in the short end of the bond market. Maybe you can creep out to five years on occasion. Some people may go out to ten.

Matching your universal life assets is an exercise on its own. Only the crazies are going to go way out in the long-term bond market. Once people settle down and start getting their planned profit margins on these excess-interest products, the return to the policyholder is going

to be something like a short-term interest rate less the margin priced into the product. In the long term, I would forecast that this would be significantly less than the returns on the investments in the separate account which do not have these inhibitions. If you look at studies done on long-term investment results, the more volatility and the less the liquidity requirements, the greater the long-term return. So, I think when we look ten years down the road in 1995 at the performance of the variable universal life and the cash values that are out there compared to a typical universal life, we are going to see that the consumer, on average, has done significantly better with a variable product than a nonvariable product. I think this will happen gradually. In the long term, we will see that the returns to the policyholder do come out better under variable life, and eventually this product will be consumer-driven rather than selfishly promoted from the point of view of the issuing companies.

When going into this product, there are a couple of myths. This is not just an up-market product. If you look at the experience in the U.K. and the experience of John Hancock and the Equitable, this is a very marketable product to the lower- and middle-income groups. Basically, it comes across as a good savings vehicle. You can have life insurance and also invest in the stock exchange on Wall Street. That has sales appeal to some individuals, as the bread-and-butter savings vehicle in the lower- and middle-income groups. You can have a look at the Hancock's sales and the Equitable's sales, and there is a lot of experience in the U.K. to support that.

Also, it is a myth that it takes experienced agents to sell this product. When you design a variable product, keep it as simple as possible. Also keep the sales material simple--easy to understand both for the salesman and, therefore, for the client. If you do that, it is probably easier to educate a neophyte sales force on the product than it is to turn on the experienced sales guy who has mastered the five dividend options. Variable universal life is not just an up-market product, and you can use new agents to sell it.

The Canadian experience points out that you must have multiple funds. If you go in with an equity fund when there is a bull market, you will have short-term success. When equities are the buzz word, people will invest in equities, but as soon as a bear market sets in, your salesmen will not want to talk about it. If you do not have anything else for them to switch to, the product will just die. It did this in Canada; it did it in Holland. If you look at the U.K., the only reason that it is continuing to sell there is that by the time the equity market crashed, the companies were into real estate. By the time the real estate market crashed, they were into money markets. There has been an interesting investment media, and the sales have continued throughout. So, have multiple funds so that there is always something for the salesman to talk about.

Assuming that these guidelines are followed and the whole thing is not hit on the head by a tax act, then I see quite a bright future for variable life insurance in the U.S.

MR. JOHN P. SCHREINER: Mr. Tuohy, you concluded your talk saying you were hoping the whole thing would not get hit on the head by the tax act, and I am not sure what you meant. If anything, I see the Treasury proposal as a possible boon for variable life. If we go ahead and find the inside build-up on life insurance policies is taxed, maybe variable life becomes that much better with municipal bond funds, capital gain treatments, and the like.

MR. TUOHY: Basically, the way a variable life policy would be taxed on its inside build-up in the President's tax proposal is that you are throwing dividends and interest income and realized gains into the calculation, but you do not throw any unrealized gain into the calculation until surrender. While this might provide variable life with an advantage over nonvariable life, it would be an advantage over a very unattractive product, the lesser of the two evils.