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VARIABLE UNIVERSAL LIFE INSURANCE

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MR. WILLIAM A. STOLTZMANN: In January 1981, E.F. Hutton Life Insurance Company received a favorable ruling from the Internal Revenue Service on their universal life policy. The ruling generated a great deal of interest within the insurance industry, and over the next couple of years, a large number of companies began to develop and market universal life policies.

When our company looked at the concept of universal life and tried to find a competitive edge relative to that product, we examined concepts developed approximately ten years earlier. If a universal life policy, which credited interest on the cash values, was attractive to customers, then a policy which had its cash values invested in various equity and bond funds as well as interest-bearing accounts, would be even more attractive. We looked at the concept of a variable universal life policy as an extension of the attractive features of universal life that had been developed by E.F. Hutton and other companies.

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Unfortunately, early in our development work for this new policy, a number of obstacles prohibited or significantly limited our company's ability to issue a contract with these additional features. These restrictions came about during the development of variable life insurance policies approximately fifteen years ago. In the early 1970s, when the insurance industry began developing variable life policies, when it was very interested in keeping the Securities and Exchange Commission (SEC) from regulating its product lines. In an effort to limit the SEC's arguments that a life insurance policy with separate account features was a security for purposes of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940, the industry developed what became known as the NAIC Model Variable Life Insurance Regulation. The NAIC regulation significantly restricted the product design features of a variable life insurance policy funded with separate accounts. Such products were required to have certain death benefit-to-premium ratios, level premiums for the whole of life, and very restrictive uses of the investment earnings in a separate account.

Despite the industry's attempts to keep the SEC out of the regulation of variable life policies, the SEC adopted Rule 6e-2 in 1976 to regulate these products under the Investment Company Act of 1940. As such, variable life policies became regulated by both the SEC and the state insurance departments. The net result of these regulations was a restrictive product design and an inflexible approach to the customer's ability to vary premium payments and to build cash values rather than death benefits.

For a good summary of the development of the NAIC Model Variable Life Regulation, Rule 6e-2 and the state and federal issues associated with variable life insurance, I would refer you to a Connecticut Law Review article written by Paul Mason and Steve Roth of the Washington law firm of Sutherland, Asbill & Brennan. That article, entitled "SEC Regulation of Life Insurance Products - On the Brink of the Universal," appeared in Volume 15, No. 3, the Spring 1983 issue.

Although my company decided to develop a traditional universal life policy after looking at the NAIC Variable Life Regulation and Rule 6e-2, we joined two groups in late 1981, which had been formed to change the NAIC regulation and Rule 6e-2. An ad hoc group of approximately thirty companies worked with the Sutherland, Asbill & Brennan law firm on this project, an American Council of Life Insurance (ACLI) task force of fifteen companies was also formed to consider changes to those regulations.

Those groups decided that in the NAIC Variable Life Regulation, a large number of provisions relating to the securities aspects of the product could be dropped, leaving the regulation of those aspects to the SEC. In addition, some restrictive policy design requirements imposed in the early 1970s to keep out SEC regulation were also

eliminated. The regulation was amended to drop the requirement of a level premium for the whole of life, the minimum multiple test wherein death benefits had to be a minimum multiple of premium payments, and the restrictive design requirements that the favorable investment performance of the separate accounts had to purchase additional death benefits rather than increase the policy's cash values directly. Minimum death benefit guarantees and maximum policy charges were also eliminated to allow companies greater flexibility in developing their products. In December 1982, the NAIC adopted these amendments to the Model Variable Life Regulation.

To date, twelve states (Arkansas, Connecticut, Delaware, Iowa, Kansas, Kentucky, Maine, Minnesota, Mississippi, Nebraska, North Dakota and Virginia) have adopted these amendments, and it is hoped they will be adopted by Indiana, Missouri, New Mexico and Texas by the end of this year. Statutory changes have been approved by California, Florida and Puerto Rico to allow the sale of this product. Pennsylvania, the District of Columbia and Washington will also require amendments to their statutes before variable universal life policies can be sold.

When the NAIC adopted the amended model regulation, it also proposed that guidelines be developed to consider how the standard nonforfeiture law would apply to this product; how a company would assure that it had sufficient net investment income and readily marketable assets to meet anticipated withdrawals; and how proposals or illustrations would be developed for this product to identify the guaranteed and nonguaranteed aspects of the policy. These guidelines are expected to be proposed at the summer NAIC meetings and may be adopted next December.

After the ACLI and ad hoc group of companies' task forces completed work on the changes to the NAIC Variable Life Regulation, they turned their attention to the Federal Securities Regulation, Rule 6e-2. The three major areas that the industry felt needed to be changed in order to accommodate the flexibility of a universal life policy design in combination with a variable life policy are the limitations on sales load contained in Section 27 of the Act; the ability of the customer to increase insurance coverages within the same policy after it has been issued; and the use of surrender charges or back-end instead of front-end loaded policies. Subsequent to the industry's submission of the proposed new rule, the issue of the appropriate level of mortality and expense risk fees developed.

With regard to sales loads, the traditional variable life policy has a schedule of premium payments that are required to be paid by the policyholder in order to keep his or her policy in force. Existing Rule 6e-2 allows the company to take 9 percent of those scheduled premium payments over a period of twenty years as sales load. Applying this approach to a variable universal life policy presents a problem because no premium payments are technically required of the customer under the current policy designs. A customer has nearly absolute freedom, subject only to some tax law limitations, to pay as little or as much premium whenever he or she desires.

In dealing with this problem, the task forces attempted to develop a reasonable way for the company to compensate its sales force and to cover its allocated marketing costs for this type of policy, taking into account the flexibility which the customer has in making premium payments. The approach which was adopted in the proposed rule was to establish guideline premiums similar to those calculated under TEFRA in order to determine the amount of sales load that would be available to the company on the sale of a variable universal life policy. Under this approach, the company will apply the 9 percent limitations to the guideline premiums over a period of twenty years to determine the maximum dollar amount of sales load which it can take.

The rule also needed to address the availability of the policy's cash values to pay additional sales loads when the customer increases insurance coverage after the policy is issued. Currently, the only way the owner of a scheduled premium variable life contract can increase coverage is to buy a second policy.

When that policy is purchased, an additional sales load is available to the company for compensation and marketing expense purposes. Under a variable universal life policy, a new policy form is not needed and new premium payments are not necessarily required. However, the sales efforts needed to sell the additional layer of insurance coverage will be nearly the same as those required under the traditional variable life concept. Therefore, the rule originally presented by the ACLI to the SEC proposed that when an additional amount of insurance is purchased at the request of the customer, the company will be able to calculate a new guideline premium for the additional coverage and calculate its 9 percent sales load over twenty years on that.

The last major modification in the ACLI proposed rule is called the Economic Value Test. It was designed to give comparability in the treatment of sales loads to both front-end and back-end loaded policies. Even though a policy has a surrender charge and no front-end load, the company still needs to be able to compensate its sales force, cover its allocated marketing expenses, and obtain a profit margin so as to make the marketing of this product feasible - just as it does in a front-end loaded contract. If the company is unable to get the same relief for a back-end loaded contract as with a front-end loaded contract, it will not be inclined to market the back-end loaded contract that is currently so attractive to consumers.

The ACLI proposed rule provided that a company using a surrender charge or back-end load will be in compliance with the rule if, under certain assumptions, the cash values and the death benefits of the policy are at all times equal to or better than those provided by a front-end loaded contract which complies with the rule. Although this approach would allow a company to take greater than 9 percent of guideline premium payments in certain situations, it was designed to put the company and the policyholder in roughly the same position they would have been in had the sales load been taken up front. Additionally, because of the mathematics used in calculating guideline premiums as well as the interplay of the standard nonforfeiture law in later years, the present value of the maximum dollar amount of

back-end sales load would be less than a permissible front-end charge.

These proposals were submitted to the SEC in the summer of 1983, and in November 1984 the SEC issued temporary rule 6e-3(T). This temporary rule made a number of significant changes to the ACLI proposed rule but also provided a comment period during which interested parties were invited to comment on the temporary rule. The ACLI and a few companies have submitted comment letters to the SEC on a number of significant points. The draft of the ACLI comment letter was in excess of 150 pages in length. Obviously, it is not possible to touch on each of the points mentioned in that letter, but I will highlight the key areas where the SEC has changed the rule from the ACLI proposal and how the industry has responded to those changes.

The areas of more significant interest or concern in the temporary rule include:

1. restrictions on the level of mortality and expense risk fees;
2. the appropriate mortality table to use for calculating the guideline premium and determining the deductions for sales load purposes;
3. refunds of excess sales load;
4. an Economic Value Test for subsequent sales loads; and
5. sales loads on increases in insurance coverages.

The ACLI proposed rule made no specific mention of any limit on mortality and expense risk fees. For variable annuities, such fees were in the range of 100 to 150 basis points, while under scheduled premium variable life policies, the NAIC model regulation limited the fees to 50 basis points. The industry would like to be able to set these fees at levels comparable to variable annuity levels. This is based upon the expense risks associated with a flexible premium policy, which can have numerous policyholder- and tax-law-generated changes in the savings and insurance elements of the package, as well as unique mortality risks which may arise from the use of less conservative mortality tables, limited underwriting, cost-of-living adjustments, and tax law corridor requirements. Although Rule 6e-3(T) prescribes no particular level of fees, it requires that the insurer represent that the level of the risk charge is either (1) within the range of industry practice for comparable flexible or scheduled premium contracts or (2) reasonable in relation to the risks assumed by the insurer.

The two companies which have gone effective with their registration statements for products arguably falling within the temporary rule's standards, have limited their fees to 60 basis points. The industry is seriously concerned that this fee level will be adopted by the SEC as the "range of industry practice" and has strongly argued that the SEC should have no control over these fees and that levels significantly higher than 60 basis points should be permissible.

An issue related to the appropriate level of the mortality and expense risk fees involves the choice of the 1958 CSO Table versus the 1980 CSO Table for calculation of the guideline premiums and the deductions which can be taken for mortality costs. The ACLI rule had proposed the use of the 1958 CSO Table and calculated the guideline premiums using that table and a 4 percent interest rate. Rule 6e-3(T) uses the 1980 CSO Table and a 5 percent interest rate. The ACLI comment letter argues that the 1958 CSO Table should be retained because the selection of the appropriate table is directly related to the business of insurance, and it is therefore inappropriate for the SEC to impose its view on the insurance aspects of this product. Although the SEC has indicated that it was not trying to force companies to use the 1980 CSO Table in their policies, but rather was just requiring its use to demonstrate compliance with the sales load limits, the rule would, in practice, require the use of that table. The comment letter points out that companies may be forced into using the 1980 CSO Table in other lines earlier than they want to, if the SEC requires the use of that table in this product. If the SEC continues to require the use of the 1980 CSO Table, the ACLI comment letter suggests that the companies should be able to use a 1980 CSO male table for compliance demonstrations in all circumstances or alternatively any "nonbiased" combination of tables. The multiplicity of 1980 CSO tables causes uncertainty in determining which table or tables can or should be used in demonstrating compliance with the rule.

The issue of the appropriate amount of sales load which can be taken under this new product appears in a number of different provisions in the rule. Initially, the question centers on the amount which must be refunded if a policyholder surrenders in the first two years. The ACLI proposed rule suggested that a refund must be made if the sales load exceeded the lesser of 30 percent of the guideline annual premium or 50 percent of the actual premium payments in the first year, plus the lesser of 10 percent of the guideline annual premium or 17 percent of the actual premiums in the second year. The SEC changed these percentages in Rule 6e-3(T) and refunds must now be made if the sales load exceeds the lesser of 30 percent of the guideline annual premium or 30 percent of the actual premiums in the first year, plus 10 percent of the lesser of the guideline or actual premiums in the second year. However, Rule 6e-3(T) adopts what has been termed an "acceleration approach" toward actual payments. If payments in excess of the guideline annual premium are paid in any year, those payments are viewed, not as "excess payments" in that year (subject to a 9 percent sales load limit), but rather as accelerated payments for later years. The ACLI has indicated that this acceleration approach should be applied to refund situations. Thus, a company would be entitled to 30 percent of the first guideline premium even if some of it is paid in the second policy year, and 10 percent of the second guideline premium whenever it is paid.

The ACLI argues for the reinstatement of the 50 percent of actual premium limit, but suggests that if the SEC does not accept this approach, then a limit at 40 percent of actual premium is a reasonable compromise. This compromise is based upon an assumption that 75 percent of the guideline premium will have to be paid by the

policyholder - assuming the use of the 1980 CSO Table and 5 percent interest - to keep the policy from lapsing in the first year and that 40 percent of that amount would equal 30 percent of the guideline annual premium (argued to be the amount of premium required under a Rule 6e-2 scheduled premium policy to keep that policy from lapsing).

The issue of the appropriate level of sales load also comes into play when a rear-loaded policy is considered. The ACLI proposed rule contained an Economic Value Test which allowed a company to take sales loads in excess of 9 percent of premium payments. Although Rule 6e-3(T) allows a subsequent sales load (a contingent deferred surrender charge, in most cases) to be taken, it does not permit that charge to exceed 9 percent of guideline premiums paid over twenty years. The ACLI comment letter argues for reinstatement of the Economic Value Test, citing the legislative history of the sales load limits of the 1940 Act, the fact that subsequent sales loads were not in existence in 1940, and the fact that, under the specified assumptions, the policyholder's position will be at least as good under the Economic Value Test as under a comparable front-end loaded policy.

One final area of the temporary rule that is important to the industry is the amount of sales load taken at the time of an increase in insurance coverage. The ACLI proposed rule suggested that the additional coverage be treated as a new policy; that sales load could be taken from the existing policy's cash value without a premium payment being required; and that there would be no new free look, refund, or conversion rights on the new layer of coverage. Rule 6e-3(T) provides that if the new sales load for the new layer of coverage does not exceed 50 percent of the otherwise permissible maximum sales load, then new free look, refund and conversion rights must be provided. I believe the ACLI position will be that the free look and conversion rights should not apply to an increase if the sales load taken on that increase would not have required a refund if the increase had been treated as a separate policy. This approach is expected to be a practical limit for insurers, so no policy would be developed which would exceed this limit. If a policy is developed which exceeds this limit, incredibly complex issues would develop concerning how to allocate premiums paid after the increase and what values should then be used for refund, free look, and conversion purposes.

The development of this product has been a very time-consuming effort, involving innumerable complexities. However, we've come a long way and are hopeful that the SEC will consider the concerns raised in the ACLI comment letter and make appropriate changes to Rule 6e-3(T). As with the variable life policy that was developed fifteen years ago, the major obstacles appear to center on the issue of sales load and how the federal securities laws can be adapted to accommodate traditional insurance company compensation and expense factors. However, this time we are also faced with internal competition from our own universal life and other interest sensitive products. If the selling representative and the company cannot obtain commissions and profits from a variable universal policy that are comparable to those from a universal

type of policy, the incentives to develop and sell the new product are greatly diminished. We are hopeful that the SEC will recognize that this product is an enhancement to the currently successful universal life design and will not restrict or inhibit its development and marketing by unnecessarily applying securities-law limitations to the life insurance aspects of this product.

MR. ZAFAR RASHID: Variable universal life provides the customer with a variety of investment choices for the cash value in a universal policy. This distinction between universal life and variable universal life has many significant marketing implications. The product is likely to have appeal only for the very upscale markets. Only the more affluent customers are likely to have the financial or the emotional wherewithal to utilize the investment flexibilities that variable universal life offers. For a substantial portion of universal life buyers, the simplicity and the lower cost of universal life are likely to overshadow the advantages of variable universal. The more affluent customers are also the more sophisticated in their knowledge of investment choices and alternatives and the most likely to want to utilize the investment flexibilities.

The product is likely to be sold by sophisticated agents and financial planners. Many of these agents and planners are accustomed to similar investment features in annuities and will be the first to make the transition to variable universal life. Another distribution source for the product is stockbrokers. These three distribution channels are very different from each other, and it is not likely that the same product will serve the needs of all three. Any company that is planning to market its product through more than one distribution channel will need more than one product.

Predicting the market potential for such a product is difficult. The product will not gain acceptance among the lower and middle income customers. Even among the more affluent customers the rate at which the use of variable universal life will spread is uncertain. Recalling our experience with universal life, it took more than two years for the product to gain broad acceptance. The learning curve for variable universal life will be longer, both for customers and for distributors. It takes a significant change in an agent's mode of operation to be capable of advising clients with regard to the movement of monies in different funds. Many agents are not accustomed to providing ongoing service and may be reluctant to put themselves in such an advisory capacity (even if they do have National Association of Securities Dealers licenses). It might be the end of this decade before variable universal life is widely accepted.

Stock market performance will influence the market penetration of this product to some extent. The current economic environment is ripe for such a product, but the long-term prognosis will be significantly influenced by the length of the current business cycle. To the extent that a company can offer a broad array of investment choices, beyond the standard stock, bond, and money market funds, the company would increase the market appeal for its product.

The differences in the design of variable universal life are traceable to either the presence of investment choices in the product or the limitations placed upon sales loads by the SEC. The sales load limitations are more likely to prove onerous to companies marketing their product through the traditional distribution channels. Business marketed through stockbrokers is likely to require less sales compensation, so the maximum sales loads permitted under 6e-3(T) may well be adequate. The administrative expense charges in variable universal life will probably have to cover all of the administrative costs, provided that such charges are "reasonable and customary."

This product is likely to be more service-intensive than universal life. The servicing demands on the agent could be reduced depending on the administrative practices that the company chooses to adopt with regard to fund transfers, and so on. However, it would be impossible to insulate the agents from renewal servicing. They will have to answer customers' questions regarding fund performance, explain transaction confirmations and annual statements, and perhaps even advise on investments. If this service proves inadequate and dissatisfies customers, the company may suffer in the long-term. Companies encouraging such ongoing service by agents will have to reward the agents via higher renewal compensation than is customary for universal life and with compensation that is tied to the investment choices in the contract.

Rule 6e-3(T) may also diminish the profitability of back-end loaded contracts because, under the proposed rule, the maximum back-end loads are not high enough to be economically equivalent to the maximum front-end loads.

One of the main items of profit and revenue is the investment spread or the asset charge. There are indications that the SEC will attempt to regulate this asset charge. One might argue that this constitutes price regulation by the SEC, but that is a legal question. The SEC is likely to force asset charges to be "reasonable and customary." One way to gauge the reasonableness of the asset charge would be to compare it with the asset charges inherent in universal life contracts. These vary widely, ranging from 1 percent to 2.5 percent. The unit investment expense associated with this business is likely to be higher than for universal life since the investment expense must be spread over a smaller base of assets than the general portfolio of the company.

The existence of investment choices is likely to cause shifting of monies from one fund to another. The volume of such activity will vary depending on the market and the distribution channel. This could become an expensive administrative burden. One solution is to institute activity charges associated with the shifting of monies. The concept of activity charges is common in universal life since most companies have them for partial surrenders, loans, and so on. The net result is that customers who want investment flexibility will pay for it.

One of the significant elements in the pricing of both universal life and variable universal life is the charge for the use of surplus to support

the business. Variable universal life transfers most of the C3 risk to the customer. However, the surplus needed to cover the C2 risks should be similar to universal life. This lower need for risk surplus to support the fluctuations in the business may offset some of the extra administrative and investment costs.

The SEC regulations are in the embryonic stage and the state valuation and nonforfeiture requirements have yet to be conceived. The prospective approach to valuation and nonforfeiture loses much of its meaning in the absence of interest rate guarantees. The industry and the NAIC need to develop a retrospective approach to valuation and nonforfeiture regulations. Pending such reevaluation, it is possible to demonstrate the compliance of this product with the existing nonforfeiture and valuation requirements in a mathematical sense, even though one may question their real meaning.

Logic would indicate that GAAP accounting for variable universal life should be similar to that for UL. At the present time, there is no officially sanctioned GAAP methodology for universal life. Companies are using a wide variety of methods, most of which make a reasonable attempt to match earnings to revenues. A current proposal before the Financial Accounting Standards Board (FASB) recommends a prospective approach to the development of GAAP earnings and a definition of revenues that is a blend of premiums collected and mortality and investment margins. However, the FASB is leaning in favor of a retrospective methodology, and defining revenues to be mortality and investment margins only. This latter approach is consistent with GAAP accounting for single premium deferred annuities and is simpler to administer, audit, and so on. Although the prospective blended approach has received industry support, the FASB is correct in leaning toward the full margin retrospective approach.

Regardless of the methodology, there are issues peculiar to variable universal life. For instance, as the fund values fluctuate, should the rate at which the deferred acquisition expenses are amortized be adjusted, and if so, by what method? In the absence of any guidelines from the FASB, it is likely that most companies would carry over their GAAP valuation approaches for universal life into variable universal life.

With increased flexibility in contracts, there is an increased dependence on computers. It is no longer possible to enter a market at the cost of printing a rate book. Substantial investments in systems and administrative capabilities are necessary to deliver and service new products. This was the case with universal life - even more so with variable universal life.

Just as universal life was a quantum leap over traditional products administratively, variable universal life is a quantum leap over universal life. In addition to the administrative complications of premium flexibility, there is a need to handle transfers of monies between funds and the movement of monies in and out of the policy through partial surrenders and policy loans. The presence of multiple funds

complicates the handling of partial surrenders and policy loans, and confirmations of transactions need to be sent. This means having to maintain a complex audit trail of everything that happens to a customer's account. It is difficult to undo and redo a transaction and to correct an error or make a change. Thus, it is impossible to service even small volumes of this business manually. A system must be capable of handling not only the usual universal life functions, but also the fund transaction, the daily pricing and valuation of the funds, and the customer confirmations. It must do so efficiently if the administrative costs are to be kept within reasonable bounds.

Companies can buy a system or build their own. The decision will depend on needs, existing systems, and the size of the data processing development budget. Buying a package will prove to be cheaper provided it can be integrated into an existing operation.

Developing variable universal life is a very capital-intensive endeavor. The resources needed go beyond the capabilities of the small or medium-sized companies. But they are not necessarily locked out of the market. Such companies can purchase the administrative services if they are willing to develop the product themselves. Another alternative is to buy both the product and the administrative capabilities from another company. Such an arrangement can be mutually beneficial since the smaller companies can have access to a product without the enormous product development or systems development costs, while the larger companies can have a means of defraying their developmental costs.

MR. JOSEPH O. NORTH: Everybody keeps referring to this product as variable universal. This is flexible premium variable life insurance. We are not talking about variable universal.

The traditional distinction between stock and mutual companies - that stock companies market nonparticipating policies and mutual companies market participating policies - has eroded over the last decade. With the introduction of nonguaranteed cost elements in stock company products, and mutual companies offering similar products as well as nonparticipating products through subsidiaries, most product differences due to corporate form have been eliminated. This trend has accelerated as the newer products - variable life, universal life, and other investment-sensitive products - have increased in popularity. These newer products contain nonguaranteed cost elements, but only a few have a traditional participating feature. Certainly the newest investment-sensitive product, flexible premium variable life insurance, will continue its development with limited distinction between stock and mutual company products.

If we assume that product design is not a mutual versus stock company issue, what will affect the design of flexible premium variable life insurance products? Regulation and taxation will greatly influence the design of these new products. Market responsiveness will also have great influence.

Different companies will offer many different product designs to differentiate their product and capitalize on a perceived marketing need. Flexible and scheduled premium product designs will utilize front loads, back loads, or combination loads for acquisition and issue expense recovery. Maintenance expenses will be recovered with charges against premiums, specific charges against policy values, or as a percentage of policy assets. Policy-provided death benefits will use the two most prevalent current universal life designs as well as others that creative actuaries will employ. The level and structure of mortality charges are likely to vary significantly by company and by market within company. A key design element that is likely to change dynamically in the future is the investment mix offered to the policyholder. How many different investment options? Is there a guaranteed-principle, declared-rate option? Is there a guarantee associated with market value of separate account investment performance?

The number and type of investment options offered pose several design opportunities. Will transfers between funds be permitted? How often? Can funds be transferred from the guaranteed-principle, declared-rate option? How will policy loans and partial withdrawals be handled? These and other product options will keep product actuaries, administrators, and marketers struggling for several years in their search for the market.

No discussion of potential product designs would be complete without a few words about the level of distribution expenses that can be supported by this product. Distribution expenses are not directly regulated by the SEC. However, the SEC will regulate the charges made to recover distribution expenses, therefore indirectly regulating the distribution expenses that can be supported by the product. In the current temporary Rule 6e-3(T), the SEC has limited sales charges to a level that will support the distribution expenses associated with most currently available universal life products. I expect that agent commission scales will have formulas similar to the ones currently being used with universal life. First year commissions will likely be a percentage of a target premium with a lower percentage on amounts in excess of the target premium, or they will be equal to the sum of a three factor formula consisting of a constant, a percentage of premium, and an amount per thousand dollars issued. Other than first year commissions will probably be a percentage of premium paid. A percentage of the cost of insurance deduction or policy assets probably will not be used.

Whatever the resulting commission scale, insurance companies (especially those which seek to develop and maintain a career agency sales force) will be reluctant to reduce agent compensation below the level they currently provide.

As increased competition develops, the pressure to gain operating efficiencies and become a lower cost producer or to seek alternative distribution outlets will increase the need for career agency insurance companies to change their traditional operating methods due to:

1. increased consumer awareness of the product;

2. the offering of similar products by banks, stockbrokers, and other insurers using mass-marketing or group techniques; and
3. the natural desire of all insurers to maintain or increase their market share.

Insurers will attempt to meet this competition by increasingly using joint ventures, alliances, third party administrators, and nontraditional distribution channels or techniques. These fundamental changes will require some difficult and sometimes painful decisions by company management. However, a healthier industry and a happier consumer will result.

The complexities required in the administration of flexible, multi-option investment products present a real challenge in developing adequate data processing capabilities. Any of you who have struggled with developing administrative systems for traditional variable life, adjustable life, or universal life can appreciate that flexible premium variable life is a significantly more complicated product. All of the various product design options, flexible payments, flexible investments, and flexible benefits that enhance the product's attractiveness to the consumer create recordkeeping problems not handled by existing insurance company systems.

The decision to modify an existing system or to seek an administrative package from a software vendor will depend on the capabilities of the company's current system, as well as the company's experience with software vendors. Either option usually involves a significant investment of personnel and financial resources.

The marketing of flexible premium variable life insurance products presents some interesting new opportunities, especially for those companies that have not offered variable products previously. This product is considered to be a security and is regulated by the SEC. This regulation, in addition to the traditional regulation of insurance by the states, places additional burdens on the insurer, especially in the areas of disclosure and licensing.

Prior to accepting an application, a prospectus must be delivered to the potential client. The prospectus contains extensive information about the product, the financial condition of the insurer, and the historical investment results and current investment objectives of the underlying funds in which the policy assets will be invested. Subsequent to policy issue, a prospectus supplement must be provided at least once a year, which updates the original prospectus with any changes in operations as well as current financial results.

Prior to or at delivery of the policy, a policy-specific illustration must be provided to the policyholder showing potential benefits, in an SEC prescribed form, assuming several hypothetical investment results. Any other illustration that an insurer may wish to use in the sales process must be filed with the NASD. This has been a burden for traditional variable life insurance and will probably continue to be so.

All sales representatives must be NASD registered representatives and have passed at least a Level VI exam. A registered representative may represent more than one broker-dealer, if each broker-dealer agrees. Many insurers, in the capacity of broker-dealer, expect to deny that multiple representation is beneficial in reinforcing the affiliation of the agent and the insurer. If the insurer is the broker-dealer, then the insurer has the additional responsibility of reviewing the compliance performance of all of its registered representatives, including those registered with other broker-dealers.

How an insurer views the potential marketplace for flexible premium variable life insurance, its role in the financial services industry, its current operational and distribution systems, and the additional burdens associated with SEC regulation will determine the insurer's response to the availability of this new product.

Will this product become the "bread and butter" life insurance product of the future, or will universal life, term, and whole life continue to dominate the market? This question is critical in any company's decision to offer this product and in a company's approach to the market. It is possible for this product to become the dominant life insurance product of the future if:

1. policyholder taxation of life insurance products is not significantly changed;
2. the product contains a guaranteed-principle, declared-rate investment option in addition to appropriate market valued investment options that are perceived as providing attractive potential investment returns relative to the risks assumed by the policyholder; and
3. the economic environment in which we live does not discourage the accumulation of assets in life insurance products.

To the extent that any or all of these three conditions are not satisfied, the attractiveness of a flexible premium variable life insurance product will be diminished. Under adverse circumstances, the product could disappear or be relegated to a niche product offered by only a few companies. Since I do not anticipate such adverse circumstances, I expect a prosperous future for flexible premium variable life insurance.

MR. MICHAEL R. TUOHY: Three different types of variable life products have been brought to the market: fixed premium, single premium, and universal or flexible premium. Fifteen companies have issued fixed premium variable life insurance; twelve are mutual companies, and three are stock companies. The twelve mutuals include Prudential, Metropolitan, Equitable, Northwestern Mutual, Mass Mutual, and New York Life. Only three companies have sold more than ten million dollars of new annual premium in a given year. Those three are John Hancock, Equitable, and Prudential.

The production numbers for these three companies during 1983 and 1984 are interesting. John Hancock sold fifty-six million dollars of new annual premium in 1983 and seventy-four million dollars in 1984. Equitable, which was the first to introduce the product, had forty-nine million dollars of sales in 1983 but realized a substantial fall to eighteen million dollars in 1984. Prudential sold ten million dollars in 1983 and forty-seven million dollars in 1984.

What happened to Equitable and John Hancock? These were the two early players in the game. Why did their production patterns differ so sharply in 1984? Both introduced a universal life product in 1983. John Hancock's product has low commissions and was not intended to disturb the strong growth of variable life sales. The result was minimal sales of universal life.

But Equitable introduced an attractive back-end loaded universal policy that caught the attention of the sales force and moved substantial volumes of business that would have been variable life into their "Life Account" product. The sales of Life Account in 1984 amounted to about two hundred million dollars of new annual premium compared to eighteen million dollars of variable life premium.

What's happened to the single premium product? Two companies that have been in the market are Monarch Life and Equitable. Monarch's sales are increasing. In 1983, they sold seventy-seven million dollars of new single premiums and in 1984, nearly three hundred million dollars. Equitable has only been dabbling with the market with sales of thirty-one million dollars in 1983 and about six million dollars in 1984.

The majority of Monarch's single premium business is sold through Merrill Lynch, and the product caught the imagination of the Merrill Lynch account executives at a time when they were looking for an alternative to SPDA sales. The Monarch surge in single premium production coincided with the Baldwin United scandal. Monarch has demonstrated that a single premium product is easy to sell through the Merrill Lynch account executives. Travelers and John Hancock have filed products, and John Hancock's was recently approved. The single premium product is a success, and we expect several other companies to go into that market.

What's happening on variable universal life? The products that have been filed with the SEC can be divided into three types: low load, high load, and Prudential's.

The SEC let it be known early in 1984 that if a product was filed with sales loads no more than 9 percent in any year, approval of flexible premiums was possible. Several companies took this low load approach: Acacia Mutual, Lutheran Mutual, Keystone Provident, Life of Virginia, USAA, and Volunteer State. The problem with the low load approach is that commissions are low, and the target is the single premium stockbroker market.

There are two types of higher load product. One is aimed at qualifying under 6e-3(T), or the eventual 6e-3. Acacia Mutual has also filed a product of this type as have Travelers, IDS, Security Benefit, Metropolitan, Mutual of New York, and Northwestern National.

The third product was developed by Prudential and is a hybrid of a fixed premium product and a flexible premium product. It's not as fully flexible as universal life. For instance, the nonforfeiture rules come into play when the cash value drops below a value close to a term-to-seventy reserve. Also, there's lack of flexibility after age sixty-five. One unique feature of the product is the death benefit guarantee if "scheduled premiums" are paid.

The argument to the SEC was that the product was a mixture of scheduled premium and flexible premium. The scheduled premium part should be viewed in light of Rule 6e-2, and any additional premiums were approvable since loads on premiums paid in excess of the scheduled premiums did not exceed 9 percent.

Prudential's and Acacia Mutual's low load versions have been approved. Prudential is in production except in about five or six states where they are awaiting approval. The states that have not yet given approval include Pennsylvania, Texas, and New York. Texas has just passed a new variable life regulation that should allow approval in the near future.

Why all this big charge into variable universal life? Why switch from the excess interest concept that's been so successful over the last five years?

It's a merger of products because the eventual variable life product will have a general account option in it. The variable part of the product can be viewed as an add-on. Ideally, begin with a current excess interest product and give the policyholder some separate account options in which to invest.

But consumer appeal is not as big an attraction as are the corporate reasons. One corporate reason is that several big life insurance companies got a nasty shock in the late 1970s and early 1980s when they found their bond portfolio down by about 30-40 percent and a negative cash flow. They're unhappy with their investment risk and happy to pass it on to the policyholder.

The other corporate reason is that insurers see this as a way to recapture their sales forces. If VUL could become the demand product of the late 1980s and the 1990s (with the sales forces asking for it), because of the SEC rules of broker dealer registration, companies can insist that their sales forces sell only their variable product.

This can have a significant impact on the acquisition costs of these companies. If Big Mutual X manages to retain 65 percent of its business as opposed to 60 percent, that additional 5 percent would be marginally costed and have a direct impact on overall acquisition costs. One additional reason why the larger companies are interested in the product is that it's expensive to initiate, and smaller companies will not be able to compete.

Consider the company that has just made the decision to go into this product. There are four alternatives:

1. Introduce a low load, low commission product, aiming at the stockbroker single premium market.
2. Use Prudential's hybrid idea. The product is approved and can be copied. The problem is that there are no software houses developing a system to handle it. Prudential did it in-house and they're not going to share it. In any event, this may be a temporary product, halfway between 6e-2 and 6e-3.
3. Design a product to comply with 6e-3(T). The problem is whether it can make money? Maybe it's better to wait for 6e-3 if it ever comes. Perhaps the lawyers will give us a bit more room for profits.
4. Design a product complying with 6e-2, which has been recently amended. One can design something equivalent to an excess-interest whole life product with separate accounts. This alternative is new and might provide a method of quiet entry. There are reasons for having a fixed premium product rather than a flexible product. For example, one could use the product in the minimum deposit market.

Assume that the decision has been made to enter the market and one wishes to distribute this product in the same way one distributes an excess interest product. We can learn something from Equitable's experience in December 1975 when they launched their fixed premium product. The original sales of Equitable during the 1970s were disastrous. The sales force didn't catch on to the product at all, until suddenly in 1980.

This can be due to one of four reasons. No one's quite sure which is responsible for the increase in sales at Equitable:

1. They launched the product with a 40 percent commission that compared with 55 percent that the agents were receiving on their par whole life sales. Later, the actuaries managed to reprice the same product to pay 50 percent, and that began to catch the sales force's attention.
2. When the product was launched, SEC ruled that one was allowed to illustrate a variable life product assuming a growth rate of only 8 percent in the underlying funds. The resulting cash values were not much better than the old participating product. When Monarch Life filed their prospectus, they managed to persuade the SEC that 8 percent was out of date and that 12 percent should be used. Everybody used 12 percent, and the resulting variable product values were much better than those under the traditional participating product.

PANEL DISCUSSION

3. They rethought their presentation to the sales force. The old fixed premium variable life product is an actuary's dream but a salesman's nightmare due to its complications. At first, Equitable tried to explain these complicated mechanics to the agent who then had to try to pass them on to the client. The presentation was simplified by concentrating on the appeal of the separate accounts.
4. The investment vehicles had become more attractive. In 1975, equities were not an attractive investment. That was the only fund Equitable had available. By 1980, that particular equity fund had a pretty good track record; the salesmen had something to brag about; and shortly thereafter, money market funds were introduced.

When introducing a variable universal life product, you have to get the commission right and the cash values must look reasonably competitive compared to those from your universal life. Make sure the presentation's simple and that you have some attractive investment medium in which to put the money.

What are the problems that will be encountered in launching a variable universal product? Profits are squeezed from every direction compared to universal life pricing. You may be used to a 150 or 200 basis point spread on universal. Unless the rules are changed, you aren't going to get anything like that on VUL.

The maximum cost of insurance rates must be based on the 1980 CSO Table, possibly causing a squeeze on mortality profits. The sales loads are limited under 6e-3(T) adding another constraint on pricing. Additionally, there are higher expenses.

To the extent that these are administrative expenses, they can be passed on directly to the policyholder, but that detracts from the competitiveness. The only favorable aspect is that you're passing on the investment risk to the policyholder. However, most universal life pricing ignores this, nullifying the advantage.

Systems is another area requiring close scrutiny. Prudential is moving because they developed systems in-house, and Travelers is pleased they made the decision to do it themselves.

Competitiveness is also a concern. A variable policy may be illustrated assuming the separate account earns 0 percent, 4 percent, 6 percent and 12 percent before all deductions, before the mortality and expense risk charges, and before the investment advisory fee. So the mortality and expense risk charge is 60 basis points, and the investment advisory fee a further 50 basis points. The 12 percent illustration would assume a 10.9 percent accumulation rate.

In comparing illustrations to UL, there's a slight advantage to UL. A lot of companies are still crediting rates well in excess of 11 percent which must imply a 13 percent earnings rate. As interest rates come

down, we'll see universal life rates that correspond to a fund earning 12 percent.

At the moment, it's about level comparing the 12 percent numbers on a variable policy with a universal policy. However, if there's a sharp drop in interest rates, the variable illustrations would be at an advantage compared to the universal, assuming that universal companies continue to show their proposals on their current credited rates. There is a danger that some agents might see this as an opportunity to replace the universal life policy that replaced a traditional policy about four years ago.

Should a little company go after a big investment name? Monarch has done well with the Merrill Lynch name. In the U.K., it was common practice for a small life insurance company in the variable market to sign up with a famous merchant bank and claim that the bank had strong investment expertise. But it will probably cost 50 basis points in investment advisory fees.

Investments can make this product spark. One of the big reasons that John Hancock did so well initially with their variable product was that they were quick to cash in on the popularity of money market funds in 1981-82. Similarly, the success story at Monarch could well be credited to their innovation of introducing a fund that invested purely in zero-coupon Treasury bonds, effectively giving a guarantee at a reasonably high rate of interest on a variable product.

There will be more innovative ideas in the type of investment medium that will be offered to policyholders. It's essential that there be something interesting for your sales people to talk about. Otherwise, the appeal of the product diminishes. We've seen this in several countries where the concept of variable life took off rapidly during a bull equity market. But products have since disappeared because there was no alternative investment vehicle when the stock market started down. In the U.K., by the time the stock market moved down, real estate funds were introduced. By the time the property market crashed, money market funds were introduced. "Golden rule number one" in developing a variable product is that there must be an attractive investment vehicle for your salesperson to talk about.

"Golden rule number two" is to keep it simple. The vagaries of fifth dividend options are not involved. Just putting the money into a bank account and watching it accumulate is something quite comprehensible to a policyholder. Putting money into a mutual fund is quite comprehensible to a policyholder and a neophyte agent. New agents are much more comfortable learning about a universal life policy than they are learning about a traditional participating policy.

The experience in the U.K. has been similar. If you keep the product design simple enough, training new agents straight into a variable product is easy. I don't agree that the market for this product is among the sophisticated investors, and that the only ones who will sell it are the experienced agents. If the products are kept simple enough, many experienced agents will be the last ones to get around to it.

They don't want to give up their traditional product knowledge to sell something that the neophyte agent is selling.

There is also experience indicating that this product can be sold to the lower income groups. In the U.K., variable products have been the regular savings plans successfully sold by many companies. John Hancock experience in this country shows that the sales force can latch onto this product successfully and sell it to all income groups.

There is very little precedent in this country on GAAP accounting for the variable life product, though Monarch has been doing it for quite a time. They used U.K. methodology as precedent. Several of the major writers of variable life insurance in the U.K. are U.S. owned and have to report on a GAAP basis.

This is a fixed premium product, so when we get to variable universal life, there will be a blending of the methods used for fixed premium variable and flexible premium universal. For a fixed premium variable product the acquisition expense asset is established in an identical manner that for a traditional product and amortized over the premium-paying period.

The benefit reserve is split into two parts. The unit reserve or the separate account reserve is equal to the amount in the separate account. The balancing item, called a general account reserve, is developed from the cash income and outgo to the general account.

Cash income consists of premiums; any charges from the funds, such as the mortality and expense risk charge and the excess of the investment advisory fee over the expected investment expenses; cost of insurance deductions; and any surrender charges that may be imposed. Cash outgo consists of the allocations into the separate account; any excess of the death benefit over the fund value at time of death; and any expenses or renewal commissions. The general account reserve acts as the balancing item that allows profits to emerge as a level percentage of premium.

For the company that cannot decide whether to develop a product, my advice would be to wait and see and not undertake any expensive development at this stage. Follow Prudential's progress closely. If their results are good, the other big captive agency forces are likely to join the bandwagon.

An administrative system is a problem. A computer system must be up and running. Consider the various software houses. Do some initial profit tests. See if 6e-3(T) restrictions would allow a product that meets the necessary profit margins. If you're not convinced from a marketing point of view that this product is a certainty, don't go charging ahead. Wait to see if 6e-3 will allow greater margins, but remember, 6e-3 may never come.

MR. JAMES KELLER: Do you see any reinsurance needs that differ from the common method of using risk premium reinsurance for the mortality charge as in universal life?

MR. RASHID: With respect to the mortality risk, the most straightforward way is with guaranteed renewable reinsurance premiums as in universal life. I haven't considered the implications of reinsuring the separate accounts.

MR. NORTH: Surplus relief will still be needed for some companies. This particular product is a little bit different from universal life in that there is a cash as well as a surplus strain since there is a need for cash under the separate account. There might be some coinsurance or surplus relief needs that would be different.

MR. TUOHY: The reinsuring company might want to keep its retention slightly lower on this type of product because the sum at risk fluctuates as the market values of the cash value fluctuate. Also, if a reinsurer introduced a separate account that was used solely for variable life or variable annuity policies, it could make that available to client companies on a direct reinsurance basis.

MR. LES WEBB*: I would like to add a few remarks on the development of variable universal life in the United Kingdom, where it is known as flexible unit linked whole life.

Flexible unit linked whole life is the fastest growing product in the United Kingdom in terms of new business. Production has grown from approximately twenty-two million on new annualized premiums in 1981 to ninety-four million in 1984. These figures are estimates because many individual companies will not release precise new business figures by product.

In the case of many companies, it is quite a "down-market product." A typical minimum premium for many companies would be two hundred pounds per annum. Most of the plans would be sold primarily for protection purposes. At younger ages, say below forty-five, the agent's initial compensation could be 90-120 percent (but possibly spread over the first two years). With this level of sales load, the product is not necessarily a good value as a short- or medium-term investment vehicle. Most insurers would have other unit linked products with lower initial commissions (25-40 percent) for such purposes. Some insurers have experienced a high proportion (20-50 percent) of the total plans being sold on a joint-life, first-death basis on husband and wife.

*Mr. Webb, not a member of the Society, is Life Marketing Manager at the Victory Insurance Company Limited, London, England.

In the last twelve months, some of the new developments have been:

1. the introduction of plans (regular premium) with negligible death benefits (i.e., more for investment purposes); and
2. the inclusion of a large range of ancillary benefits within the life product, including
 - a. disability income,
 - b. hospital cash,
 - c. lump sum or permanent total disablement, and
 - d. waiver of premium or suspension of plan during redundancy.

The United Kingdom is quite different from the USA and our experience will not necessarily be repeated here.