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VARIABLE LIFE/FIXED AND FLEXIBLE PREMIUM

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- o Product designs
- o Market factors
- o State regulation
- o Security and Exchange Commission aspects -- Impact of final version of 6e-3(T)

MR. RANDALL MIRE: Fred Bellamy is a partner with the legal firm of Sutherland, Asbill and Brennan. For those of you not familiar with Sutherland, Asbill and Brennan and its contribution to variable life, it has been heavily involved in variable life from the very beginning. It has played a major role in the industry proposal that led to 6e-3(T). It has represented a substantial number of the companies that have filed variable life products. Fred in particular has specialized in the area of variable life since he joined the firm.

MR. FREDERICK R. BELLAMY: As you probably know, variable insurance products, including scheduled and flexible premium variable life, are subject to two entirely separate regulatory schemes. In addition to being subject to state insurance regulation, variable insurance products are subject to regulation by the Securities and Exchange Commission (SEC). I will give you a brief overview of the many ways that variable insurance products are subject to regulation

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under the Federal securities laws, and I will focus mostly on how and why the SEC, in effect, regulates profits and charges on variable insurance products, including the insurance charges, especially on flexible premium or variable universal life insurance. Then I will bring you up to date on the SECs current interpretations and applications of rule 6e-3(T), some of which are hard to reconcile with the terms of the rule itself.

Historical Background

In the 1930s and 1940s, Congress enacted a series of laws designed to curb the abuses that had arisen in the 1920s in the securities market. These abuses included not only a lack of disclosure regarding investments, but also exorbitant sales loads and hidden fees and profits, especially in the area of contractual plans and periodic payment plans. Those kinds of plans involved periodic payments of relatively small amounts, to accumulate in an investment fund, and generally had very high sales loads in the early years. This sounds to me a little bit like life insurance, at least variable life insurance.

To correct these abuses, securities were required to be registered with the SEC, and sold through registered broker/dealers with the use of a prospectus that discloses all charges. In addition, entities whose primary business was investing and reinvesting in securities were subject to additional substantive regulation as investment companies. The sales load was strictly limited, and other fees and charges for these periodic payment plans were specifically made subject to SEC regulation.

The federal securities laws define "securities" so broadly that all life insurance and annuity contracts arguably might be deemed to be securities. Therefore, Congress expressly excluded life insurance and annuity contracts from the SEC requirements on the basis that they were adequately regulated by the state insurance departments, and generally were not viewed or treated as securities. It is important to note that under the annuities and life insurance policies in existence when Congress enacted the securities' acts, all of the investment risk was borne by the insurance company, not by the policyholder, since the company guaranteed a specific rate of return.

Similarly, without an exemption, the life insurance company itself would be deemed to be an "investment company" because its portfolios typically are invested primarily in securities. Again, recognizing the proper role of state insurance laws, Congress excluded insurance companies from the definition of "investment company." Thus, up until about the late 1950s, insurance products were not subject to any type of federal regulation.

Variable annuities were developed in the 1950s, and although Congress excluded all life insurance and annuity products from SEC regulation, the SEC went ahead and asserted jurisdiction over variable annuities. In doing so, the SEC argued that the statutory exclusions should not apply to contracts where most or all of the investment risk was borne by the contract owner, instead of by the insurance company. Passing on the investment risk made SEC disclosure regulation and sales load limitations necessary and appropriate, in the SEC's view. The SEC took the position that the traditional mortality risk assumed by the insurance company under the variable contract, was not sufficient to justify continued exclusion from the federal securities laws. The SEC's position in this regard was upheld by the Supreme Court.

With respect to the variable annuity separate accounts, as opposed to the annuity policy, the SEC took a similar position that the separate account should not be viewed as part of the insurance company. Rather, it should be viewed as a separate and distinct entity, issuing securities (the variable annuities), rather than an entity issuing life insurance or annuity contracts. Therefore, the SEC took the position that the separate account was not entitled to rely on the insurance company exclusion from investment company regulation. This decision was also upheld in court. Therefore, variable annuities are subject to regulation as securities, and the segregated asset account, or separate account, is subject to regulation as an investment company.

The current regulatory structure for variable annuities is that a variety of exemptive rules have been adopted under specific sections of the Investment Company Act to provide the exemptive relief that most annuities typically need, but there is no single exemptive rule that governs all aspects of SEC regulation of variable annuities.

SEC regulation of variable life insurance got off to a different start. Beginning in the late 1960s, the life insurance industry attempted to persuade the SEC that the statutory exclusion for life insurance should apply to variable life, and that variable life contracts were significantly different from variable annuities. The industry sought to resolve this issue by proposing exemptive rules that would exclude variable life from federal securities regulation. The industry argued that the significant minimum death benefit guarantee distinguished this product from variable annuities. The SEC staff initially determined that variable life raised many of the same concerns as variable annuities, since even under variable life, the policyowner would assume a significant risk with respect to the cash value.

In 1973 the SEC concluded that scheduled premium variable life was indeed a security and that it was a periodic payment plan type of security, subject to the restrictions on sales load and other charges. However, the SEC initially proposed to totally exclude variable life separate accounts from regulation as investment companies, on a condition that a state regulatory pattern be developed that would provide comparable protections.

In response, the industry worked vigorously towards adoption of a model regulation for the product that would satisfy SEC concerns. The model regulation, as adopted by the National Association of Insurance Commissioners (NAIC) in 1973, did contain significant constraints on product design in order to assure the SEC that the product would be primarily insurance, rather than an investment. In some states that still have the old model, those constraints could pose a problem today for flexible premium variable life.

Despite adoption of the model regulation, the SEC in 1975 changed its position and rescinded its proposed exclusion for variable life separate accounts. Instead, in 1976 it adopted a more limited exemptive rule (Rule 6e-2), that provided some relief from the substantive provisions of investment company regulation. Rule 6e-2 tailors the Investment Company Act restrictions to fit scheduled premium variable life insurance. The rule substitutes its own restrictions for the 1940 Act restrictions, especially in the area of sales loads.

During the early 1980s when industry members first became very interested in variable universal life (VUL), or flexible premium variable life, they assessed that it would simply be impossible to escape SEC regulation, and therefore, no attempt was made to exclude variable universal life from SEC regulation. Instead, an industry group developed and proposed a comprehensive rule for regulating variable universal life products. In November, 1984, the SEC adopted a temporary rule, Rule 6e-3(T), which largely reflected the industry's proposal.

The current regulatory structure is that at the state level, both scheduled and flexible premium variable life are, of course, subject to insurance regulations. Some 7 or 8 states still have the restrictive 1973, or old model variable life insurance regulation, while others have adopted a new regulation, based on a new model regulation promulgated by the NAIC in 1982, which is specifically designed to permit variable universal life insurance.

At the federal level, scheduled premium variable life is subject to investment company regulation as adjusted and tailored by Rule 6e-2 under the Investment Company Act. Flexible premium, or variable universal life, similarly is subject to investment company regulation as adjusted and tailored by Rule 6e-3(T), under that Act. Policies marketed as single premium variable life insurance have been registered with the SEC under both Rules 6e-2 and 6e-3(T), depending on the particular aspects of the policy. Which rule is applicable is an area of uncertainty that the SEC is currently focusing on, and I will get back to that in a little bit. Since the VUL policies are securities, they are subject to regulation under the four major federal securities statutes.

The Securities Act of 1933 prescribes certain filing, registration and disclosure requirements which must be met before a security can be publicly issued. A security cannot be sold until a registration statement filed with the SEC has been declared effective. This process includes receiving and satisfactorily responding to comments from the SEC staff. For variable life insurance as well as for variable annuities, it also involves SEC staff approval of virtually all of the charges.

Upon a sale of a variable product, a prospectus must be delivered which contains certain specified information, including audited financial statements of the issuer. In the context of the variable products, this includes financial statements of both the separate account and the insurance company, since the SEC views those two entities as co-issuers of the security. Prospectuses and all sales material (including illustrations) are subject to potential antifraud liability under this statute, as well as others.

The Investment Company Act of 1940 regulates the operations of investment companies which generally are defined to include entities which are engaged primarily in investing in securities. As I mentioned, insurance company separate accounts are deemed to be investment companies.

The 1940 Act places limitations on the amount of charges that can be deducted in connection with the issuance of a security, especially those that provide for periodic payments. There is no direct limitation placed on expenses, but specific limits are placed on the contract charges, depending on the kinds of expenses they are designed to cover.

Specific numerical limits are placed on the amount of sales loads that can be deducted. Generally, the average sales load deducted cannot exceed 9% of total payments. The first year sales load cannot exceed 50% of the payment during that year, and the load must be level after the first year. There is also a refund rule in the 1940 Act which requires that, on surrenders in the first 18 months, there must be a refund of all sales loads in excess of 15% of payments.

Specific numerical limits are not placed on other charges. Instead, these charges must be "reasonable." The SEC staff will tell you what's reasonable, that is, reasonable in relation to the expenses the charges are designed to cover. Charges designed to cover investment management expenses can include a profit, but administrative charges cannot include any element of profit.

Rules 6e-2 and 6e-3(T) have modified, but not eliminated, these requirements for flexible premium variable life insurance.

The 1940 Act also governs voting requirements and other matters of corporate governance. Investment company shareholders, in this case the variable product policyowners, are entitled to vote on several matters including:

a) the election of directors or managers of the separate account, or directors of an underlying mutual fund;

b) approval of the investment advisory agreement;

c) approval of changes in the fundamental investment policies; and

d) approval of the independent public accountants for the separate account.

The 1940 Act also includes a variety of operational requirements, some of which have posed problems for variable life. The most important of these are daily processing requirements.

This includes several things:

a) The investment company shares or units must be valued daily, which means that all the assets have to be valued daily.

b) Purchase payments and redemption requests must be processed daily based on the next computed unit value.

c) Contract owners must be able to redeem their entire investment at any time.

d) Payments made by the investment company generally must be made within seven days of when the redemption request is received.

e) The 1940 Act also includes extensive recordkeeping and reporting requirements.

The Investment Advisors Act of 1940 requires the registration of entities that manage the assets of investment companies, including separate accounts.

Investment advisors owe certain fiduciary duties of loyalty to their clients, and in this case, the ultimate client is going to be the policyowner, not the insurance company. The investment advisor also is subject to recordkeeping and reporting requirements as well.

The Securities Act of 1934 provides that the persons engaged in selling securities must be registered broker/dealers with both the SEC and the NASD. Antifraud rules also are contained in this statute, and broker/dealers must supervise the activities of their sales representatives to assure compliance. This Act also contains specified requirements regarding minimum net capital requirements and recordkeeping.

There are a couple of exemptions from the federal securities acts that should be mentioned briefly. Insurance company separate accounts that issue products exclusively for use in certain qualified plan markets are excluded from the substantive provisions of virtually all the federal securities statutes. There is a private offering exemption which says that private offerings are exempt from the 1933 Act and the 1940 Act requirements, but not the antifraud requirements in the 1934 Act. This exemption is rarely used in the insurance policy context, except that is may be used for certain funding agreement type contracts.

There really is not an exemption for real estate since real estate generally is not a security. Therefore, you can establish a separate account investing in real estate that would not be investing in securities, and it would not come within the definition of investment company. So, real estate separate accounts can avoid 1940 Act regulation if they are properly structured, and a few of these are in existence. The policy funded by the real estate account would be registered under the 1933 Act, but the separate account would not be subject to the 1940 Act requirements.

Creation and Regulation of Necessary Entities

Turning to the structure of the registered separate account briefly, variable life and variable annuity products must be funded through a separate account. Separate accounts registered with the SEC can take one of two forms. There is the managed separate account, and there is the unit investment trust. A managed investment account operates like a mutual fund, and consists of a portfolio of stocks, bonds or other securities. The principal advantage of a managed separate account is that it is simpler than the unit investment trust structure and, therefore, costs less to establish and operate. However, the voting requirements for managed separate accounts tend to be more onerous. Proxies sometimes must be resolicited again and again, to attain a quorum for the voting requirements that I mentioned earlier, and this can be quite expensive. But I think the principal disadvantage of the managed account structure is that it limits investment economies of scale and flexibility. It is company specific because the portfolio securities are owned by the insurance company through the separate account, and therefore even affiliated insurance companies issuing variable products generally must establish their own separate accounts with separate investment portfolios. The managed separate account is also product specific. A different separate account generally is necessary for annuity and life insurance products, and a different separate account may even be required for each individual annuity or life insurance product.

Most companies, especially in recent years, have chosen the Unit Investment Trust (UIT) structure. The UIT separate account is a passive pass-through entity. Its assets are not the ultimate investments in stocks, bonds, or money market instruments, but rather consist solely of shares of a designated mutual fund, which in turn invests in stocks, bonds, or other securities. Thus, the UIT structure involves two layers, the separate account and the underlying mutual fund, both of which are investment companies.

Under the typical unit investment trust structure, the mutual funds cannot both sell their shares directly to the public and to UIT separate accounts. Rather, the shares are issued only to separate accounts. This restriction is necessary under recently enacted Section 817(h) of the Internal Revenue Code, in order to assure that the income and gains on the mutual fund shares are not passed through to policyowners on a current basis for tax purposes. Obviously most policyowners are buying variable products to avoid current taxation.

Because the UIT structure is more complex with its two layers of investment companies, it is a little more costly to establish. However, voting procedures are less onerous because proportionate voting eliminates the problem of obtaining a quorum. The insurance company votes shares that are not voted by policyowners, and the mutual fund availability of the UIT structure offers the potential for much more investment economies of scale than a managed separate account. Variable annuity and variable life separate accounts of affiliated insurance companies generally can invest in or share the same underlying mutual fund, so one fund can be used for different products. And if a special SEC exemptive order is obtained, a single mutual fund can be used as the investment vehicle by any number of separate accounts of either affiliated or unaffiliated insurance companies for any type of variable insurance product, so one fund can be used by other insurance companies. This has become known as shared funding, and the SEC has issued several such shared funding exemptive orders.

The Fidelity group has received an SEC order permitting Fidelity's Variable Insurance Products Fund to be sold to any separate account of any insurance company. Scudder, Stevens and Clark has also received a shared-funding exemptive order for the Scudder Variable Life Investment Fund. The Equitable has reorganized certain of its separate accounts into the Hudson River Fund, and obtained a shared fund order. So, at least three mutual funds are currently being offered to any interested insurance company as a funding vehicle for either variable annuities or scheduled premium, flexible premium, or single premium variable life insurance. The Hudson River Fund has four different portfolios, while Fidelity and Scudder each offer seven portfolios, and three of each of those seven are zero-coupon bond portfolios. Shared funding of this type offers long range opportunity for reducing investment expenses. It also enables any insurer to use a recognized name, like Fidelity or Scudder, in its marketing efforts, and may also result in better investment performance.

The structure of the separate account, be it managed or unit investment trust, does not affect the types of securities that serve as the underlying investment basis for the policies. Regardless of the structure, I think experience has clearly shown that a variety of investment choices is required. At a minimum, most products offer a stock fund, a bond fund, and a money market fund. In general, you have to allow the investors or policyowners to switch their funds among these accounts, perhaps with some restrictions, but you do have to allow switching for viable, marketable products.

Innovation is not really necessary, but it can help. A unique or exotic choice such as a gold fund, perhaps a zero-coupon bond fund, or a mortgage securities fund, can be used as a marketing tool, and may even have better than average investment performance. A general account option offering a fixed rate of return is also a possibility. Variable annuities have offered a general account option for years, and although an SEC exemptive order may be necessary, the SEC will permit the general account option for variable life insurance.

Turning now to Rule 6e-3(T), I mentioned that it modifies and tailors some of the Investment Company Act's requirements for flexible premium variable life insurance. The principal modifications are in the area of sales load. To begin with, Rule 6e-3(T) contains a special definition of sales load for variable universal life policies. The amount of sales load with respect to any given premium payment is defined as the excess of the gross premium over certain specified amounts. This, in effect, means that everything is sales load unless it is specifically excluded from the definition.

The sales load is measured against the "payment." As originally adopted, the definition of payment presented a significant problem. It has been defined as gross premiums less any portion of those premiums charged for substandard risks, incidental insurance benefits, and interest charges on modal premiums. This was based on Rule 6e-2, the schedule premium life insurance rule, and deducting charges for substandard risks and incidental insurance benefits was appropriate and workable under that rule since it had a schedule of premiums. However, under flexible premium variable life insurance, premium payments cannot be determined in advance, so these charges have to be deducted from the cash value. Excluding those charges from the definition of payment not only reduced the base against which the sales load is measured by a very large amount, but at times that amount might not be determinable in advance. Therefore, as originally adopted, Rule 6e-3(T) was unworkable. This was brought to the SEC staff's attention, and in July, 1985, the definition of payment in Rule 6e-3(T) was amended to correct this problem.

Since we have the definition of payment straightened out, the entire gross premium is deemed to be sales load except for the following items that are excluded:

1. charges for the cost of insurance based on the 1980 CSO table;

2. mortality and expense risk charge;

3. charges for expenses other than sales expenses, such as administrative charges and premium taxes;

4. any portion of the payment assessed specifically for substandard extras;

5. charges for riders;

6. interest charges on modal premiums; and

7. dividends on participating contracts.

In addition, the net premium, the amount actually allocated to the separate account, which increases the cash value, is excluded from the definition of sales load.

Because of the flexible nature of premium payments under variable universal life policies, a special rule was needed if the sales load was not to be limited to the 9% of each actual payment, which is the general standard. Accordingly, the industry developed and the SEC accepted the concept of a guideline annual premium. The guideline annual premium assumes the policyowner will pay guideline premiums over the life of the policy, where the guideline annual premium equals the level amount that would be payable through the maturity date to provide the future benefits, under the contract, using the 1980 CSO table, and assuming interest at an effective annual rate of the greater of 5% or the rate guaranteed in the contract. The guideline annual premium is used to measure the permitted amount of sales load.

The Cumulative Sales Load Test, which modifies the limit in the 1940 Act, is based at least in part on the guideline annual premium concept. Rule 6e-3(T) limits the sales load on flexible premium policies to 50% of payments made during the first year, and 9% of the sum of the guideline annual premiums that would be paid during the period equal to the lesser of the 1980 CSO table life expectancy or 20 years. As an alternative, you can of course limit your sales load to 9% of each payment. In addition, the percentage deducted from each payment may never increase with time. This is known as the "stair step" or "non-increase" rule.

The Refund Requirement has also been modified by Rule 6e-3(T). If the contract is terminated during the first two years, any "excess" sales loading, as defined in the Rule, must be refunded. These various limitations in effect prohibit a sales charge based on a dollar amount per thousand of face amount, unless such a load is capped at an appropriate percentage of payments. The same sales load limitations apply regardless of whether the sales load is a front-end, a back-end, or a combination front-end and back-end load. In this respect, the SEC specifically rejected the industry's request that upon a back-end sales load, the insurance company gets compensated for the time value of money. More recently, the SEC staff has been applying the "stair step" rule to back-end sales loads, even though literally under the terms of the rule, it would not seem to apply.

With respect to increases, Rule 6e-3(T) does permit an additional sales load to be deducted upon an increase in face or specified amount. The rule permits a full sales load on increases if the contract provides the contract owners with free look, conversion, and refund rights as to the increase. However, if such rights are not provided for with the increase, then the sales load is limited to 50% of what would have been permitted on an initial purchase of that amount. Now, since 6e-3(T) was adopted, there has been a great deal of uncertainty as to exactly what this 50% limit really meant in particular cases. There is still some uncertainty but a few things have been cleared up.

First, it does not mean that the total charge is limited to 4.5%, that is half of 9% obviously. Therefore, a level charge of 9% or less is permitted for increases without providing the free look, refund or conversion rights.

Second, if such rights are not provided, then a first year sales load on the increase is limited to 15%, or 50% of 30%, rather than 25%, which would have been 50% of 50%. Third, payments after the increase must somehow be allocated between the initial contract and the increase for sales load purposes. This allocation can be in proportion to the guideline annual premium for the initial contract and the increases. The allocation does not have to be by relative face amounts. That is a favorable outcome for the industry.

This allocation of payments after an increase is not required by the terms of Rule 6e-3(T), since the rule specifically states that, in applying the sales load limitation rules to increases, it should be assumed that guideline annual premiums are paid both for the initial contract and for the amount of the increase. The staff instead is focusing on the possible actual payments, and is simply not implementing or permitting reliance on the rule's specification of assumed payments. I think that the permanent rule, when it does come out, will reflect the staff's current informal allocation requirement and lack of reliance on assumed payment of the guideline annual premiums.

I mentioned the free look right, that requires a refund of the cash value plus charges if the free look right is exercised shortly after the contract is purchased. The staff very recently has adopted the tentative position that this requires a refund of not only the cash value plus sales loads, monthly deductions, and administrative charges, but also a refund of

1. the mortality and expense risk charge;

2. the advisory fee paid by the underlying mutual fund;

3. and the underlying mutual fund's actual expenses to the extent allocable to a particular contract. This would require quite a number of calculations to determine the amount of each item attributable to a particular policy, since these items would have to be calculated for each day of the free look period.

As I mentioned, this policy has only recently been adopted, and the PRUCO VUL policy is not subject to this interpretation. PRUCO's exemptive order does not require that it refund the mortality expense risk fee, the advisory charge, or the underlying fund expenses. So, it sometimes pays to go through early before the staff gets very high up on the learning curve, and starts changing its minds about certain things.

Under Rule 6e-3(T), as well as 6e-2, the SEC regulates other charges besides sales load. There are no numerical limits on administrative charges, but they must be reasonable in relation to the expenses assumed. Anticipated profits cannot be built into administrative charges. Back-end administrative charges must also be "cost-based," and the SEC interprets this to mean that back-end charges cannot reflect either the time value of money or lapse rates. Again, that is a more recent interpretation that was not specifically applied to some of the first policies that went through.

The cost of insurance charges are not directly regulated, but to the extent that the cost of insurance charges exceed amounts based on the 1980 CSO table, under the assumption that I specified earlier, the charges are deemed to be a "sales load."

The SEC's regulation of the mortality and expense risk charge has been quite controversial, and there has been a lot of activity in this area in the last year. Things have settled down a bit and some fairly clear standards have emerged. The risk charge was not regulated by the SEC under Rule 6e-2 for scheduled premium variable life because the old model variable life regulation limited the charge to 50 basis points. However, this charge has become an issue for variable universal life. I personally think the SEC staff expected this charge to remain at the 50 basis point level for flexible premium variable life insurance, and the first few companies to register flexible premium products fought a tough, uphill battle to get approval for higher charges. The first two flexible premium products to clear the SEC, Acadia's and PRUCO's, both came out of the SEC registration process with 60 basis point mortality and expense risk charges, although Acacia initially sought a much higher charge. Again, I think the staff then expected the 60 basis point charge to establish industry practice. But many companies continued to press for higher charges. The SEC's reaction has been to require that the charge, whatever it is, be risk justified. Specifically, this means that the company must represent that the level of the charge is either within the range of industry practice for comparable products, or is reasonable in relation to the risks assumed by the insurer under the contracts.

In addition to this general risk justification, the SEC staff has established informal limits on the amount charged. For flexible premium products, the staff will not allow a mortality and expense risk charge in excess of 90 basis points, regardless of what kind of justification the insurance company presents. If any company wants a higher charge now, it's going to have to appeal to the Commission itself. In addition, if the charge is 75 basis points or higher, then the company must submit a memorandum to the SEC staff justifying the level of the charge before the registration statement will be declared effective. This memorandum will undoubtedly be prepared by an actuary, and it's going to be reviewed and either approved or disapproved by either a lawyer or financial analyst. I am not sure that is going to make you all too happy. For charges below 75 basis points, the memorandum justifying the charge must be on file with the company for inspection by the SEC staff if it so desires.

For pure scheduled premium variable life policies filed under Rule 6e-2, no mortality and expense risk charge currently exceeds 50 basis points. I think it is unlikely that the staff will permit a higher charge for pure scheduled premium policies. However, there are scheduled premium policies that allow some flexibility in premium payments. Such products may allow dump-ins or the payment of extra premiums or higher than scheduled premiums, and they may allow skipping premium payments if the cash value is sufficiently large. Although such policies are filed under Rule 6e-2, the SEC staff will permit a mortality and expense risk for that type of policy of up to 60 basis points, so far. The PRUCO policy falls into this category, and I think others are following.

As I mentioned earlier, single premium variable life insurance policies have been filed under both Rules 6e-3(T) and 6e-2. A pure single premium policy that has absolutely no flexibility for additional payments must be filed under Rule 6e-2. For those policies, the maximum mortality and expense risk charge will be 60 basis points. Some single premium policies have a certain amount of flexibility, and if you could convince the staff that you should file those under Rule 6e-3(T), then such policies can charge up to 90 basis points for mortality and expense risks. Therefore, it can make a great deal of difference which rule a single premium policy is filed under. The SEC staff is just beginning to address the issue of how much flexibility is required in order to be able to file a single premium policy under Rule 6e-3(T).

Of course, the insurance industry has always maintained, so far as I know, that the SEC has no jurisdiction to regulate insurance charges. In fairness to the SEC staff, and so that you have a better understanding of the basis for its concerns in this area, I will briefly summarize what I understand to be the staff's principal justification.

For many registered insurance products, both variable annuities and variable life, the sales commission paid to agents exceeds the explicit sales load on the policies. The insurer must make up the shortfall somewhere; that is, there must be a profit in some other charge that is used to help cover the sales commission and other distribution expenses. Since there can be no element of profit in any administrative charge, the profit must come from the insurance charges, especially the mortality and expense risk charge. Therefore, to the extent that the insurance charges are not reasonable in relation to the insurance risks, the SEC staff views such insurance charges as simply a disguised sales load. Not only does the SEC clearly have jurisdiction over sales loads, but a charge that is a percentage of assets, (which the Mortality and Experience charge is) could clearly exceed the sales load limitations, especially when added to the explicit sales load that is frequently at the maximum level permitted, particularly for the so-called refund-proof policies.

Therefore, the staff must be convinced in each case that the mortality and expense risk charge is a reasonable insurance charge rather than a disguised sales load. As I indicated earlier, the staff has determined that charges for flexible premium policies below 75 basis points are, in effect, presumed to be reasonable insurance charges. For all charges above 75 basis points, and in some cases even the charges below that, the SEC staff does insist on seeing and approving the written justification.

Confirmations

Generally, rules under the Securities and Exchange Act of 1934 require that a confirmation of each transaction be sent to the investor immediately after the transaction. Transactions for our purposes include premium payments, cash withdrawals, policy loans, transfers between portfolios, and so forth. For flexible premium variable life insurance, some companies have requested permission to send only an annual statement confirming all transactions during the year. These attempts have not been very successful, except in very limited circumstances. In particular, certain automatic premium payments effected through a third party, such as automatic checking account drafts or debits, payroll deductions, and government allotments, can generally be confirmed annually, while other transactions must be confirmed on an immediate basis. For scheduled premium variable life, an annual confirmation of premium payments is generally permitted.

Timing

With regard to the time it takes to clear the SEC, we have not seen any appreciable improvement despite the SEC staff's promise to expedite the process. After the initial filing with the SEC, you should expect that a product with no new wrinkles will not be declared effective for at least four to six months. Of course, you have to add to that the time it takes to design the product and then prepare the documents prior to filing with the SEC. A product with a feature that the SEC has not seen before, or one it has seen but not focused on, would take longer to clear.

Prognosis

I will finish up with a fairly dangerous exercise in crystal ball gazing. I do not think we will see the adoption of a permanent rule for flexible premium variable life until very late summer at the earliest, probably not until this fall or winter. Although the SEC staff in the Office of Insurance Products has moved very far up the learning curve in the last year, it scrutinizes each filing very carefully, and continues to give priority to processing registration statements and exemptive applications over work on a permanent rule. In fact, earlier this week, Cathy McGrath, the Director of the applicable division at the SEC, repeated in a public hearing before the Commission her often-stated complaint of being short on both professional and support staff. On the other hand, the Office of Insurance Products just completed a substantial project with the adoption earlier this week of Rule 151 for interest sensitive general account annuities, such as single premium deferred annuities, and it is our hope that the staff's energies can now be focused on a permanent rule for flexible premium variable life insurance.

I will go out on another limb and predict that the permanent rule will be substantially the same as the temporary rule, but with some clarification or minor modification in a few areas, such as sales loads on increases, and as I indicated earlier, less reliance on assumed payment of guideline premiums to demonstrate sales load compliance. Accordingly, since this is how the SEC staff is currently applying the rule, I do not think that companies that have cleared the SEC or that design a product based on the staff's implementation of the temporary rule will have to make major modifications to their product when the permanent rule is adopted.

MR. MIRE: Our next panelist is Gil Fitzhugh who is Senior Vice President and Actuary at PRUCO Life. PRUCO Life is the stock subsidiary of the Prudential Insurance Company which sells its variable life products. As most of you are aware, Prudential is recognized as the industry leader in variable universal life insurance. Gil obviously has been heavily involved in the development of Prudential's variable products and its continued outstanding success.

MR. GILBERT W. FITZHUGH: I think it is a safe bet that most of you are not in the variable life business. For those of you who are, the chances are you have gotten into it rather tentatively. You may be piloting in a couple of states, or you may be just getting through the SEC maze, so you are here to learn something and explore some ideas.

At the Prudential, we are very much into this business. We are in it with both feet. There is nothing tentative about it. We sell fixed premium and flexible premium variable life in every state. I can say that, and not be a liar as we do not sell it in the District of Columbia, where nobody can sell variable life, but we are in every state. I think we are also in Guam.

Two years ago, universal life was typically crediting 13% or 14% on a current basis. The conventional wisdom said that a successful Universal Life (UL) company could not succeed in developing and introducing variable life, because the agents would rather sell a 14% sure thing than a stock fund. Well, we did not think that that was true then, and we sure don't think it's true now. We were very unenthusiastic latecomers to universal life. When we finally introduced it, we made a number of changes to the product because of our different environment. We have an enormous inforce of small policies which were very vulnerable to replacement. We did not want other companies to replace these policies, and we sure did not want to encourage our own agents to replace it. We wanted a reasonable level of premiums that would give us an ongoing cash flow, out of which we could support not only our home office expenses, but also the field force. We figured the typical UL contract pays a lot of commission to replace all your business, and after that you do not get much. So we created a UL contract that was a hybrid with scheduled premiums and tabular values, and then we put all these features into our variable universal life contract, and filed it under 6e-2. We had about as weird a variable universal life contract as anybody is likely to come up with, although I understand we are being copied, which is very flattering. I have not seen any copies yet.

Universal Life has never become the star of our portfolio, but we do write a comfortable amount of it. We also write a tremendous amount of VUL. That is why we have never been convinced it was impossible to do both. But even if the conventional wisdom had some merit back in those halcyon days of 14% interest rates, we do not think that that position has any merit at all today. There are a lot of companies that are still trying to hang onto a 10% credited rate on universal life, and you are probably wondering how long they can do it. If they cut their rate too soon, they are going to lose a lot of sales, and if they cut their rate too late, they are going to lose a lot of money. This would be a much easier time to introduce VUL if you have a mind to go through all of this regulatory hassle, and get your feet wet. Agents do not like selling 12% opportunities against 14% current rates, but they are probably willing to sell 12% opportunities against 9% current rates.

I said we are in this business with both feet. Let me show you where the Prudential family is in the product revolution. I would like to talk about what has happened to our permanent portfolio in the last eleven calendar quarters. The universe is comprised of permanent policies with a face amount of $25,000 or more. We do not have any interest sensitive products in the smaller policy series. So, to compare apples and apples, the traditional permanent here is only the relatively big policies. The yardstick we use is the scheduled premium.

It started in the third quarter of 1983 when we introduced our first new generation product, fixed premium variable life insurance (VLI). Sales started slowly in the third quarter of 1983, and I will tell you a little bit more later about why they did start so slowly. They peaked after a year to almost a fifth of sales. At the time we had maybe 60% of our field force licensed to sell it. That is an approximate figure. It is up to about 70% now. I understand the Equitable claims to have licensed 80% of its field force. My hat is off to the Equitable. I do not think we will ever get close to that.

In the third quarter of 1984, we introduced a current assumption whole life contract. At the time it had a 12% credited rate, and it took off pretty fast. It took a little bite out of variable life, but it took an enormous chunk out of traditional. One calendar quarter later, we introduced our hybrid version of UL, also with a 12% current credited rate. This caught on quite quickly, mainly at the expense of current assumption whole life. The latter was truly a flash in the pan product. One calendar quarter after UL, we introduced VUL. Now VUL is outselling traditional whole life by three to two in face amount. They are about equal in scheduled premium. VUL is outselling general account UL by more than three to one in premium. This is partly due to the fact we have felt we can be quite bold in bringing our new money credited rate to more realistic levels. We are currently crediting 8.5% on new money on the UL and current assumption whole life contracts, and we are going to 8% in June. The current assumption whole life has virtually disappeared, and the fixed premium VLI has settled into a fairly comfortable steady level of about 5% of sales.

These numbers are even more dramatic if you realize that while the traditional policies and VLI policies on here have face amounts of at least $25,000, the UL, VUL, and current assumption whole life contracts have a $50,000 minimum. Therefore, there is a good amount of the traditional and VLI that could not be sold on the new forms. It is also dramatic if you realize that this represents only our annualized scheduled premium. On our UL and VUL contracts we have had a very rapidly growing volume of drop-ins.

Currently, we are getting drop-ins at issue roughly equal in aggregate to the level of scheduled premiums. We do not know what that means because we have not been in the business long enough. We do not know whether we are going to get renewal premiums in addition to the initial drop-ins. We also do not know whether we are going to get renewal premiums at a higher rate than scheduled premiums, or whether drop-ins simply represent prepayment of future premiums in the policyholder's mind, so we are not going to get anything in the future. We do projections of renewal premiums, but we do not really believe them.

Now I would like to talk about our total sales. Like most companies we have a cyclical trend through the year. Our sales peak in the fourth quarter, and then the agents start to fill the pipeline at a much lower level in January. But given this pattern of sales rising and falling throughout the year, one can see that each year we have been selling more than we sold the year before. While the volume of traditional whole life is down, our total volume has been rising significantly. UL and VUL have partly cut into our traditional business, but a lot of what we are writing is new.

There are some other points which may be of interest to you as to what has happened to our business. We have tried to track internal replacement by our UL and VUL policies; it seems we are getting replacement in about 11% to 12% of our UL and VUL sales. That is more than we would like, but it is much better than we expected. We have taken considerable steps to discourage internal replacement. I know some companies have gone the other way, and are actually paying to roll it over. We definitely do not want to do that. Very early returns suggest that the persistency of VLI, UL, and VUL business is better than that on traditional business. Again, we are not quite sure what that means because UL and VUL do not lapse on the same basis as traditional business. We are also wondering whether it is because the contracts are more attractive and stay inforce, or whether it is because we have a partial recapture of first year commissions in the event the contract does not go through the second anniversary. What we hope is not happening is that the agents are putting their cats and dogs in Prudential, and giving us the good stuff. Obviously I would like to get the good stuff, but we would rather they did not write the cats and dogs at all. We might be getting that kind of distortion because the agents' commission is not at risk in the event of a second year lapse on a traditional contract, but it is in a variable or universal contract.

There has also been a very interesting side effect of our move to VLI and VUL. We are currently pulling in close to ten million dollars a week in variable annuity premiums, and we are pulling in around forty million dollars a week in mutual fund contributions from agents. In our peak week, we had forty-nine million dollars of mutual fund contributions. This happened just a couple of weeks ago. Now, it has dropped off again, but it is currently running about forty million a week from essentially zero two years ago.

I will pass along a few useful lessons that we have learned from our entry into this business, in the hopes that they will be useful to you if you are considering getting into it as well. First of all, the SEC is slow. It does not understand insurance. It thinks it is dealing with a complicated mutual fund. It has 600 lawyers and no actuaries. I do not know whether that is good or bad, but it does not speed things up, that's for sure. The people there speak a different language from the state insurance regulators we are used to. If you decide to take the guy who normally files your forms with the state and say, "All right, while you are at it, do these SEC documents and file them," I guarantee you are doomed to failure. It will not work. You are going to have to have competent Washington counsel.

On the other hand, things are getting somewhat better with the SEC. There are companies that are on the street. When we first went into this business we were told to not do anything that is in anyway different from what is already out there, because if the SEC does not understand it, you will never get through. So we unabashedly copied the Equitable VLI contract. We are very grateful to the Equitable for having broken new ground. Our contract was so much like the Equitable contract that we could almost change the logo, take the glasses off, and you would not know the difference. But when we went into VUL we were very much breaking new ground, and yet we were on the street a year and a quarter after making the decision to start. That includes work on agent training, state licensing, and SEC work. Now with 6e-3(T) contracts coming on, there are enough of them that the SEC is getting a little bit more comfortable. I would imagine that if you choose to be on the street a year from now, you will be able to do it. Even if there are some changes to 6e-3(T), I agree with Fred, I think the preliminary work is going to be 98% good, even if they change the regulation a little bit between now and the time you go effective.

The second lesson we learned, which probably does not affect most of you that much, was that the critical path for us was systems, not the SEC. Our contract, as I said, is weird and we elected very consciously to put it on our regular ongoing system. That is the same one we have had for a number of years, which does all of our fixed premium traditional life insurance. We treat the products like everything else: the same reports, management, awards, administration, valuation, and premium collection. It all churns out of the same pot at the same time, and that is a good amount of systems work. If on the other hand, you have a plain, vanilla traditional UL contract, I would imagine that adding the separate account package to run your cash value would not be that tough. There are software firms that do it. If you are trying to create a contract like ours, you will have systems problems.

Third lesson -- back-loading is attractive and has a lot of sizzle, but a disappearing back-load on a VUL product is a surplus hog. A lot of us were at the session on Return on Equity (ROE) and heard that there are two good ways to improve your ROE. One is to make the R bigger, and the other is to make the E smaller. If you go into a disappearing back-load VUL, you make the E bigger, and that does not help. What happens is that you are telling somebody that ten years from now, if he stays with you, he is going to have the value of whatever his stocks are. He will not have it if he surrenders early, but he will have it if he hangs around ten years. So, you have to buy the stocks. The law makes you do it, and prudence makes you do it. There is no way that you are going to guarantee somebody that ten years from now you are going to give him something that could go through the moon. So you have to put up the money. That means you take your surplus, and you stick it in your own stock fund. That makes an ROE calculation difficult.

Fourthly, the SEC loading allowances are ample in aggregate for persisting policyholders. There are lots of ways that you can make a profit off this business with persisters. The problem with the SEC is that it does not give a very good upfront allowance for early terminators. In your existing business you have probably worked out some kind of livable balance between what the agent gets, what the early terminator gets, what the persister gets, and what the company gets. The SEC puts its thumb on the scale in favor of the early terminator, and that is probably not the person most of us choose to favor.

That is why we put in a partial commission recapture in the event of a termination of our business within the first two years. When we first proposed that, there was a little mushroom cloud sitting above the corporate office building, because as you know, talking about commission recapture is not exactly a way to get invited to the cocktail party for the agents. The fact is that is had gone down virtually without a ripple. We have been selling variable life since the third quarter of 1983, that is almost three years. That provision has been in there from the start and we do not hear about it. We explained why we had to do it, and we are selling lots of it.

The fifth lesson is that a variable product was a major change for our field force. I said I would tell you a little bit more about why sales started so slowly. We had a registration effort. Everybody had to take an NASD exam, and several of them more than once. We went through a tremendous amount of paperwork, getting our initial VLI contract approved in the states, approved by the SEC, and on the street. We figured, this is the new wave, here it is, it's on the street. We were just going to sit back and be showered with applications.

Well, we were not showered with applications, and the reason was the agents were terrified of this thing. They are used to selling guarantees. They are very conservative people personally for the most part. A good amount of them did not know what the devil a stock fund was. They also are required to sell through a prospectus. I don't know how many of you have looked at a prospectus for a variable life product, but it is a formidable document. It spells out expenses in excruciating detail, and is the most negative document you will ever read on any subject. This did not sit well with the agents. They were very much afraid of being asked to explain what is in the prospectus; how do you use these expenses, and if I want to be a closet actuary, how do I compute my cash value? The agents did not want any part of it.

We asked ourselves what to do next. We had incurred a significant expense in setting this up. What we did was to set up a bunch of dog-and-pony shows. We took some of the sharpest home office people in our marketing area who were former agents. Wherever we could gather a hundred agents and run a meeting, we ran a meeting. The guys running the meetings were smart. They knew that even though they used to be in sales, they were now in the home office and that made them the enemy. None of the sales people would believe anything they said. When they had a meeting, they knew that there would be a few people in the crowd who had sold a few contracts. They would ask, "How many of you have sold one contract?" Maybe a quarter of the hands in the room would go up. "How many have sold more than one?", and hands would go down. "How many have sold five?" Two hands would stay up. Our folks had done their homework. They had picked the guy they wanted, and would say, "Joe, would you mind if we brought you up here and asked you some questions about some of the things that are troubling people? How do you handle all those expense charges in the prospectus? What do you do when people ask you to explain the mortality and expense thing with the 60 basis points or whatever?" And the answer is, Joe doesn't. People don't ask. Joe doesn't worry. He sells the concept, he sells the sizzle, he gets the money and goes home. And then he does it again.

Once the agents started telling other agents that the horrible prospectus full of no-nos was not a problem, the other agents started selling. Once agents started selling, we began to see this pattern of results. As the interest started to grow, the money just came in. We had one agent who had announced his retirement early. We introduced VUL, and the first week it was on the street he sold fourteen of them and rescinded his retirement. He said he had never had so much fun. I cannot promise that your whole field force will do that. Our whole field force certainly has not done that. However, this is very popular, very exciting business, and if you can learn to go through the horror show it takes to set it up and get it going, I think you might have some fun with it.

MR. MIRE: Our last panelist is Mike Tuohy. Mike runs the New York office of Tillinghast. Mike has been involved with a large number of clients concerning the development of variable life insurance. Mike is going to give us a review of the products currently being offered and filed with the SEC, provide us with some industry production results, and tell us what the considerations are if you decide to introduce variable universal life.

MR. MICHAEL R. TUOHY: As you will see, the Prudential story is not the story of the majority of companies that have introduced variable life. I am going to look at the products by splitting them into the three categories: first of all, the fixed premium products, then the single premium products, and finally the flexible premium or variable universal life.

The first fixed premium product came out in late 1975. The Equitable had been working on it for about six years, and introduced it in November 1975. The field force greeted it with a big yawn. Nothing really happened with that product until the 1980s. John Hancock introduced its product in 1980, Monarch followed in 1981, and Bankers Security in 1982. By 1982, Hancock and Equitable were having considerable success, and the product got the interest of several other companies; New England, Prudential, Mass Mutual and Metropolitan introduced products in 1983, Manulife, New York Life, Provident Mutual, Northwestern Mutual in 1984, and then Crown, First Investors, and Security Mutual in 1985. That list includes several companies, but only a few met with success. We have heard about the Prudential. The other two companies who have had significant success with their fixed premium variable life product are Equitable and John Hancock. Several of the smaller companies have claimed marginal success, but for the great majority of the big companies, results have been disastrous. I think Mass Mutual, Metropolitan, and New York Life have hardly sold anything. In summary, 15 companies have introduced fixed premium VLI, and only 20% of them claim a major success; Equitable, John Hancock and Prudential. Recent sales results have been as follows:

Variable Life New Annual Premium

$ Millions

	1982	*1983*	*1984*	*1985*
Equitable	$41.6	$48.5	$18.3	$ 9.9
John Hancock	31.9	55.5	73.6	80.7
Prudential	N/A	9.9	47.2	35.0

What happened to the Equitable? The Equitable was charging along nicely in 1983, then a sudden cutback. In late 1983, it introduced a fairly sexy universal life product. It was up-to-date and back-end loaded. Clearly, universal life took over from the Equitable's fixed premium variable product. But I do not regard this particular contest between universal and variable life as totally fair. The universal product was very much state-of-the-art, and the fixed premium variable was the same old thing that had been sold since 1975, -- a fairly ugly design. As you will see, when we get to the flexible premium products, Equitable has recently introduced its version of variable universal life. It is going to be very interesting to see what wins out now between the Equitable's universal and variable universal life products. That is the history of the fixed premium products. What is happening with single premium?

Single Premium Production

$ Millions

	1982	*1983*	*1984*	*1985*
Equitable	$N/A	$ 31	$ 6	$ 2
Monarch	11	77	297	497

There is a long list of companies which have a single premium product, but very few of those have been in the market for very long. In fact, it is only Monarch and Equitable for which we have any sales results at all.

We have found that there is considerable interest in getting a single premium product to the market by several companies. In fact, we are experiencing many requests for development of the single premium product at the moment, as compared to the flexible premium. I think the strategy is to cash in on the current tax status, on the grounds that the rules will change before very long. I believe we will see single premium variable take a big chunk of the single premium whole life market over the next two years. The latest single premium variable products are being designed very similarly to the non-variable single premium whole life products. There are no specific cost of insurance charges, just an additional charge on the fund. For instance, Prudential charges 60 basis points on the fund, rather than actually pulling out a cost of insurance charge that varies by sex, age, and smoking habits. So, there is considerable interest in this product, but we have a track record on only two companies.

Equitable has been in and out of the market. It brought in a product in 1983, which met with mild success, but was then withdrawn. But Monarch has had considerable success. Monarch has been marketing through Merrill Lynch account executives, and it started to boom in the middle of 1983, when several of the Merrill Lynch SPDA producers were displeased with Baldwin United and other carriers rumored to be in trouble. Single premium variable life was found to be a very viable substitute for an SPDA sale.

A second reason for Monarch's success was that in 1984 it had the very good idea of introducing some zero-coupon bond funds. These are separate accounts consisting of just one investment -- a zero-coupon treasury bond maturing at a particular date. So, you could invest in the zero-coupon bond that matures in 1995, or the zero-coupon bond that matures in 2000. If you think this through, basically what is offered is a variable product with a guarantee, not quite a dollar guarantee, but it is very close. For example, if you have some school fees to pay in 1995, you can lock in pretty much a guaranteed value using these zero-coupon bonds.

This was a very good idea. It was received very well with the Merrill Lynch account executives, and of course, during 1984 and 1985 interest rates were significantly higher than they are now. I think if you look at Monarch's sales recently, the shift has been away from those zero-coupon bond funds into the equity fund. But during that period it really turned on the Merrill Lynch account executives. This is just one example that in the variable business, if you really want to make a big bang in the market, you have got to think of the sexy investment idea. You have it here with the Monarch zero coupon bonds; you also had it in the U.K. with the first company to come out with real estate separate accounts.

Let us now look at the flexible premium market. I am going to divide flexible premium products into two types: low load and high load. Low load products are ones with sales loads of 9% or less. For the most part, these were introduced to satisfy a pre 6e-3(T) SEC requirement that only products with sales loads of 9% or less could be approved. Generally the companies that have employed this approach have had the early approvals. Acacia was the first product that was approved. Originally it had filed a high load product. The SEC would not review it, and Acacia submitted the low load product, and was first on the market. The other low load products include: Life of Virginia, Keystone Provident, and USAA. Keystone Provident is really looking at this product for use in the single premium market, and USAA typically has very low loads anyway. The problem with the low load product is that, unless you are selling it in the single premium market, you really cannot afford the same level of commissions that a life insurance agent is used to getting. To date, the production levels at Acacia and Life of Virginia are not very good. This may be partially due to administrative problems.

The high load product has a sales load in the first year in excess of 9%. There has been quite a lot of activity on this product. Let us look at the ones that have been approved, and talk briefly about their successes. Acacia, after 6e-3(T) came in, obtained approval for its high load product. The results on that product have also been disappointing. Century Life of America is the old Lutheran Mutual; it has only recently obtained approval, and no sales results are available. Equitable's product has also recently been approved, and it really is going to be interesting to see how its VUL matches up against its UL. Gil was right, that Equitable has 80% of its sales force registered. We would expect a similar domination of permanent production by the VUL product at Equitable as we have seen in the Prudential.

I do not know about Metropolitan. Fourth-hand feedback says sales are low. MONY is very disappointed in its results. It went to great effort to get the product on the street in very quick time, which it did very efficiently. It got the product through the SEC much faster than we would have expected. It also had a country-wide televised presentation to its agency force who then quickly ignored it. Metropolitan is very disappointed with its results and is completely rethinking its promotional approach.

Northwestern National and Southwestern are the first PPGA companies that have introduced VUL. I have not heard results from either of those two companies. At the same time Southwestern was launching its new product, it decided to fold into Philadelphia Life. So, maybe the response from Southwestern will not be that great.

The list of companies awaiting approval from the SEC increases everyday. However, the single premium list is growing even faster.

As you can see, levels of success vary. You have the Prudential waving the big banner, and probably Equitable doing the same, and with the fixed premium product, John Hancock is successful. But there are a lot of stories that go the other way. So, let us try to analyze why some make it and some do not.

To start, let us go back to the Equitable in 1980. It had been marketing its fixed premium product for about four years, and the product was not getting off the ground. The Equitable was wondering what it had to do? Well, when it introduced that product back in 1975, the Equitable introduced it with a 40% commission, compared to 55% on its traditional products. The differential between 40% and 55% was too high. By some magic, the Equitable managed to reprice the same old product, and found that by 1980, it could afford 50% commissions. So, one of the reasons, the Equitable thinks, for its turnaround was it brought its commissions into line with the commissions its agents received on other products.

Secondly, back in the 1970s, the maximum rate you could illustrate on a variable product was 8%. If you used 8% on the Equitable's variable product, you ended up with results very similar to its traditional permanent whole life product. So why should the agents go through all the bother of getting registered, and lug these huge prospectuses around with them when the numbers churning out in the end were no better than their good old traditional products? But in the early 1980s it was Monarch, in fact, that got permission to use a more realistic gross rate (for those times) of 12%. You know what happens if you accumulate money at 12% rather than 8%. Variable products suddenly become much more competitive than the traditional products.

The Equitable also had a look at the way it was presenting the products, and this backs up what Gil said about the way the Prudential presents its product. As I said earlier, the Equitable variable life product is really an ugly beast.

If you try and dig into the mechanics it is hard enough for an actuary to understand, but for the poor salesman who is trying to communicate it to the policyholder, it is fairly impossible. When the Equitable first launched the product in 1975, it tried to get into the nitty gritty of the mechanics of the thing, explain it to the salesman, and he was expected to do the same to the policyholder. The Equitable reevaluated this approach, and came up with a completely different sales approach which stressed the pizzazz of an equity fund, stressed the results that came out, and did not spend too much time on the mechanics. Basically, simple presentations are absolutely essential for this type of product.

Finally, the fourth reason for the Equitable's success was that the equity fund which very few people had been investing in in the 1970s, had started to do extremely well. Over the last four years of the 1970s, the Equitable separate account achieved a very good track record. By 1980, the agents had something to boast about. Back in 1975 and 1976, the equity market was down, there was no performance, and really, it was no aid in selling the policy. By 1980, you had this good performance, and people were interested in investing in the Equitable separate account.

These four reasons for success at the Equitable are worth bearing in mind for anyone designing a VUL product -- comparable commissions, competitive illustrations, simple presentations and attractive investment vehicles.

Let us have a look at Monarch's experience. Monarch came up with the single premium variable life product. Its commissions were at least as good as those offered for SPDAs. The illustrations were reasonably competitive. Monarch did develop a very simple presentation. You really have to get simple if you are going to get a Merrill Lynch account executive to sell. As far as an attractive investment vehicle, we touched on Monarch's great idea of zero-coupon bonds, which immediately caught the imagination of the salesmen.

Your greatest competitor when you introduce a VUL product is your existing UL product. Prudential had the foresight when designing its UL product to know that it really had VUL in mind the whole time. So all Prudential did with its VUL product was to put a separate account in the place of its UL accumulation account, and nothing else changed. The VUL was as competitive as the UL, with the same commissions and the additional attraction of some interesting separate accounts. Gil discussed the simple approach to the sales presentation.

Let us now consider a new company going into this product. Again, commissions are important. Don't think you can introduce a VUL with all its desirable features with the same distribution system at a significantly lower commission. Those desirable features seem to get ignored if you do that. Try to pay commissions that are acceptable to the sales force. With respect to competitive illustrations, again I will stress your biggest competitor is your existing universal life product. What are the problems that you will have in beating your existing universal life product? When you design your VUL, you have to remember that SEC design limitations have an inhibiting effect on profitability.

Compare the margins in a typical UL to those available in a VUL. First of all, the maximum sales load you are going to be able to impose in the first year is about 30% of premium, if you want to avoid administratively impossible refunds of loads. If you add on typical loads for administration, the best you are probably going to be able to do is to end up with a load that gives you a first-year cash value of zero. At the higher ages, cash values greater than zero are likely. If you have a front-loaded UL, first year cash values are probably similar. If you have a back-loaded UL, you probably have substantially higher back-end loads.

VUL cost of insurance rates are limited to a maximum of 1980 CSO, probably the same limitation you have with your UL. Some 1958 CSO products are still around, but most products now have cost of insurance rates within the 1980 CSO limitations. The big difference may be the interest spread. What spread, or the equivalent of a spread, can you pull out of a VUL product? You can pull 90 basis points out as a mortality and expense risk charge if you go to a great lengths in describing or justifying the risks to the SEC. In addition to that, you can make some profit on your investment advisory fee, but in all probability, you are going to be very, very lucky if you make 25 basis points. If you do, you have the equivalent of a 115 basis spread. If you have a UL product that is priced to give 115 basis points, or less, you are going to be able to compete. However, the majority of UL products have higher spreads than those built into them, and some are up in the 250-300 basis point range. (These are theoretical spreads, generally not being realized.)

Given those limitations, you have to think how you are going to design a VUL product to beat your UL product. If you have a UL product with a heavy back-end load which relies on a big spread, you are not going to be able to beat it, because that big spread is hidden. If this hidden spread is reduced to 115 basis points, then charges that are not hidden must be increased. We have worked with several companies trying to design a VUL that competes with their UL, and clearly the ones with the biggest problems are those with the big back-end loads and the big spreads. If you have a front-end loaded product and a low spread, you are in good shape.

The next requirement is simplicity. I am not going to repeat what Gil has said, but, it really is important to somehow get your agents to feel comfortable with the prospectus. I think the way the Prudential went about it was great, and I would really listen and take note of what Gil has to say.

With respect to investment vehicles, if you can think of the next hot investment like zero-coupon bonds, then you are going to get a big chunk of the market. They only seem to come up about once every ten years, so you have to be lucky, but there may be something innovative out there, such as a gold fund or an international fund. If one could put together a real estate fund, that may be the one, but you would have to ask Fred about the SEC implications. You speak to one lawyer and they say it is impossible, and you speak to another and they say it is okay. You would be breaking new ground with the real estate fund. There are a couple of variable annuities that I am familiar with that claim to have a real estate fund. However, it is really a mortgage fund with some equity kickers.

Let's assume you've decided you want to go into this game, how long is it going to take you, and how much is it going to cost? Well, Gil was more optimistic than I would be. He thought you should be able to do it within twelve months. My estimates are you would be very unlikely to do it in less than twelve months, but I agree with Gil that it is not the SEC that is going to be your critical path, it is your administrative systems.

Let us have a look at some costs. If you were to go to a reputable actuarial firm it may cost you $50,000 - 75,000 to do the product development. Then, I would split the SEC cost into two parts: the first is product-related, such as production of the prospectus, probably you are in the range of $90,000 - 150,000. This includes both legal and printing costs. Those things cost a good amount to print, and then you have to print them again in renewal years. You also have to have the separate accounts audited. So, those are very ball-park numbers. The more you copy someone else, the lower the initial cost; if you try to be innovative, you can easily exceed that upper number.

The second is the SEC distribution-related costs; it all depends on the size of your field force, and how many of your agents are already registered. We have put out a ball-park figure of $280 per agent. I think, Gil, you were a bit higher than that, about $300.

MR. FITZHUGH: Our training cost was about $140. By the time you pay for their variable licenses, if you do it for $250, I think you are doing pretty well.

MR. TUOHY: It just depends how much you make the agent pay, and how much you are going to pick up yourself, whether you put him through school, or he puts himself through school. The point is that, if you are going to be serious about selling this product, it is probably necessary to put your agents through school.

Additional costs may be incurred if you get some help with insurance department approvals -- perhaps $10,000 - 20,000. Therefore projected costs, prior to any estimates of systems costs, are in the range of half a million, before any recognition of the soft costs of your own people.

What should the systems' costs be? The systems people will tell you some nice low numbers, but it is unlikely to be less than half a million, assuming you are going to buy a system and put it in yourself.

So, the total costs are not insignificant, you are getting up into the million dollar range. If you ask the Prudential how much it cost to get its VUL off the ground, you might hear something like eight times that number, Mutual of New York spent about three or four million, and a similar amount for the Equitable. This is not an inexpensive game to play.

Getting a VUL product off the ground is different from a normal product development exercise. You need a task force of at least four people that can make decisions. Otherwise you are going to wander down one path, and find you have to come back again. You need to involve an actuarial representative who is doing the profit testing and other actuarial work. You also need a lawyer involved to make sure you are not profit testing something the SEC will not approve. Keep in mind that the rules are moving the whole time. Some of the statistics in this presentation were brand new. We did not have them several months ago. So, you have to have your lawyer keep abreast of what is going on in Washington, and have him okay the design every time you change it.

Similarly, you have to have a systems person there that knows something about the system you are going to buy. You may think you have the ideal product, except that it does not make enough profit. Therefore, something has to give. Do not give on something until you have checked that the system can handle it.

Of course, you have to have a marketing person, but a marketing person that can make decisions. You do not want to spend six months developing a product, and then the marketing representative shows it to the senior marketing person and he says he does not like it. So, it is important that all four of these people have to be at the decision-making level. That really is important because we have seen it with clients where they have not had one of those four involved. They spend a lot of money developing a product that just does not go.

Let us look at how this product measures on an after-tax basis. If the new tax rule goes through, it will be a big plus for variable life insurance. I have compared direct involvement in equities via a mutual fund versus a variable annuity. I have prepared a numerical example, assuming that the equity fund (mutual fund) and the variable annuity both grow at 12%. That is split between

4% dividend income and 8% capital growth. Currently we would assume that the dividend income in the direct investment is taxed at 50%, and the capital growth at 20%, and that the profit on the variable annuity is taxed at 50%. I will just give you the 20 year numbers. If you put $1,000 in a mutual fund, you would end up with $5,811 in 20 years, after-tax. However, if you put the same amount into a variable annuity, you would end up with only $5,323, after-tax, so you would be off 10%.

Now, if the new Senate tax bill goes into effect, and everything goes to 27%, the comparison is very different. The mutual fund goes up to $6,573, but the variable annuity is way up above that to $7,312. Both of these figures are after-tax. So, from a tax point of view under the new Senate bill, putting money into a variable annuity as compared to a mutual fund becomes more attractive for a higher rate taxpayer. Of course, if you put this into a variable life insurance policy, with the added advantage of no taxation on death benefits, it becomes even more attractive.

The question is, if you are sitting there quite happy with your UL product, why should you move into a VUL product and spend a lot of money? Well, the conventional wisdom has been rather selfish from the life insurance point of view. A lot of investors and insurance companies got hurt in the late 1970s and early 1980s with the spike-up of interest rates. It would be better to pass that onto the policyholder next time and not go through those uncomfortable times. Second, the registration of the sales force through the broker/dealer gives one a much better opportunity to recapture a sales force that is brokering business. Because the salesmen must be registered with a particular broker/dealer, you at least have control over variable sales, if you want to have that control. Those are the main two reasons for VUL coming from the insurance company's point of view.

I think in the long term, the demand for this product is going to be consumer driven because long-term results of a variable policy are going to be superior to those on a universal policy. There is another session at this meeting concerning matching of assets and liabilities, and where you should be investing your universal life assets. You are going to conclude that you should be at the short end of the bond market, not totally short, but fairly short. That is where people will have to be with universal life money. Once sanity returns to the market, that rate, minus a margin, is all you are going to be able to pass onto your policyholder. That is going to compete with the total investment freedom of your variable policy, where there are no such restrictions on what the investment people can do with the money. Given that scenario, I think that 10 or 20 years down the road, we are going to end up with much happier variable life policyholders than universal life policyholders.

MR. HAROLD G. INGRAHAM, JR.: Gil, are your top producers supporting this product -- the producers who were selling in the executive compensation market where tax leverage is often characteristic of the sale?

MR. FITZHUGH: Yes.

MR. DICK CLARK*: With regard to the refund on the free look, and the SEC's new position, does it ever require return of more than the premium paid in?

MR. FITZHUGH: If things went up, yes.

MR. BELLAMY: Yes, their position is that under 6e-3(T), if you are returning the cash value plus the charges, that could be either more or less than the initial premium, depending on investment performance.

MR. FITZHUGH: And, there are a couple of states that require you pay these premiums back.

* Mr. Clark, not a member of the Society, is with the Travelers.