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VARIABLE PRODUCTS -- A STATUS REPORT

Moderator: MARY ANN BROWN
Panelists: WILLIAM E. CONNOR
RODNEY R. ROHDA
STEPHEN E. ROTH*
Recorder: BRUCE M. JONES

- o Sales results
- o Securities and Exchange Commission and state regulatory developments
- o Systems availability
- o Product design
- o Investment options

MS. MARY ANN BROWN: During the past two and a half years, we have seen an intense increase in the interest in variable products. This is mainly due to three reasons. First, companies are crediting lower rates on the competing interest-sensitive products, although some companies feel that these are still higher than they should be. Second, companies feel less comfortable about the asset-liability risk than they did in the past, and this is partly due to the upcoming valuation actuary standards. Third, companies would like to get more of their agents' business. This has them associated with their broker-dealers, and also increases their sales volume by use of stockbrokers. In addition to all this, companies' interests have been supplemented by the interest of the mutual fund and banking industries, who are attracted to the tax advantages that are currently in life insurance and annuity products.

* Mr. Roth, not a member of the Society, is an attorney with the law firm of Sutherland, Asbill and Brennan in Washington, District of Columbia.

It will be interesting to see how long single premium and life insurance products retain the favorable taxation of distributions; that is, the provisions for loans and partial withdrawals. The scare last week was again postponed when the attempt to add Stark/Gradison's proposal to the Budget Reconciliation Act failed. However, we will probably see a successful attempt to hit life insurance products before next spring if Stark and the Ways and Means Committee have their way. The proposed grandfathering date is set at October 7, but we still don't know exactly what will be grandfathered. The single premium variable products will probably not be hurt as badly as their fixed account counterparts if the distribution advantages alone are removed. This is because the loan advantages are usually not the focus of the sale of variable products. If they are, then the policyholder should probably buy a fixed account product instead because the loan of the variable product is transferred to the general account, which prevents the loaned amount from participating in the variable account performance. But some are questioning this performance potential of variable products if the stock market continues to decline as it did last week. But remember that, unlike the situation in the seventies, variable products are now positioned to take advantage of many different markets, since they have diversified investment options. Various stock accounts with differing betas, money markets, bonds, managed accounts . . . as well as others such as gold and real estate are predicted to do well.

One last comment I will make before I introduce our panel is the trend toward using outside fund managers for these products. In fact, several funds have established portfolios specifically to be shared by insurance companies. These funds include Fidelity, Scudder, American Pathway, Neuberger and Berman. And Dreyfus, American Capital and Oppenheimer are on the way in this direction as well. Many more mutual fund managers are also working on such ventures. These are especially to be used by insurance companies who want the name, reputation, or expertise that is offered by a major investment house.

Now some of the leading players in the variable product industry are on our panel. First, we have Steve Roth, of Sutherland, Asbill and Brennan. He is one of the top Securities and Exchange Commission (SEC) insurance attorneys in the country (but I don't think the National Association of Securities Dealers (NASD) would approve of those kinds of words). I can attest to his reputation, having had the pleasure of working on many client projects with him. He has been extensively involved in the design and regulatory clearance of variable life and annuity products for the past eight years. Steve will discuss the recent SEC and state regulatory developments with you, and he will include 6e-3(T), (that's for the flexible premium variable life reproposals), and the annuity regulation 26a-3. Because the Society almost gave him an honorary FSA a few years ago, he has agreed to talk more like an actuary than a lawyer.

Second, we have Bill Connor who is vice president and actuary for Pruco Life Insurance Company. This is Prudential's stock sub that is responsible for Pruco's variable and other nontraditional products. Bill has held a variety of positions within Prudential, and he's been heavily involved with the development of Prudential's several variable products. He will discuss sales results for the industry, as well as some of the newer, and more popular investment options, such as the real estate and general account options.

Third, we have Rod Rohda, of Fidelity Investments Life Insurance Company. Rod recently took what could be termed a "leap of faith" in leaving a succession of old line mutuals, like Northwestern Mutual, New York Life, Mutual Benefit and Home Life, to become president of Fidelity's insurance subsidiary. Fidelity is the Boston-based mutual fund giant. In a little more than seven months, he has hired a staff, developed and filed two variable products, and is well on his way to bigger things. Rod wanted to talk to you about the culture shock involving things like how his car was stolen the day after he moved to Boston from New York. But he has reluctantly agreed to discuss issues such as why he thinks variable products didn't work the first time around, and why he thinks they will work this time. He will include some comments regarding software and other decisions he has made in the process of pursuing his goals this year.

MR. STEPHEN E. ROTH: I am going to focus on the regulatory developments that have occurred in the past year. There have been a number of regulatory developments, particularly in the last 6 to 8 months. First, I am going to talk about reproposed SEC Rule 26a-3 under the 1940 Act which, if adopted, would permit and govern the amount that could be deducted as mortality and expense risk charges from separate account assets. Second, I will discuss recent amendments to Rule 6e-3(T), the 1940 Act exemptive rule governing flexible premium variable life. Finally, I will talk about recent state developments affecting variable life insurance.

Beginning with reproposed rule 26a-3, that rule was published in February of this year, comments were solicited, and the comment period ended in June. Those comments are now being considered. This reproposed rule is the latest in a long series of SEC approaches to regulating mortality and expense risk charges deducted from separate account assets. To understand the importance and significance of this proposal, one needs to view it against the backdrop of the original proposal 26a-3 published in 1984, the manner in which the staff has been regulating these charges over the last couple of years, and the industry objections to the original 1984 proposal.

In the 1984 proposed rule, the SEC attempted to codify an approach that it had evolved over the years. Under that 1984 proposal, in order not to violate the 1940 Act, and at the same time deduct the risk charge from separate account assets, a registrant had to represent one of two things, and had to have actuarial memos in its files backing up those representations. The first representation was that the charge was in the range of industry practice for comparable products. Alternatively, a representation could be made that the charge was reasonable in relation to the risks assumed. The staff wanted some mechanism to avoid having to approve registration statements under the 1933 Act, that had what they termed to be either *unduly high, excessive* or *abusive* risk charges. So they conditioned the availability of this 1940 Act exemption on the 1933 Act registration statement, having voluntarily been declared effective by the SEC staff, rather than having been automatically effective under the statute.

After this rule was published, the SEC announced some guidelines that it was going to use in processing individual registration statements. It indicated that basically it was really only comfortable with the industry practice standard. It didn't really understand what "reasonable in relation to risks assumed" meant, and it had a pretty good idea in its own mind what industry practice should be, namely, and they have stated this publicly. A charge in excess of 125 basis points for variable annuity contracts would not be viewed favorably by the staff. A charge in excess of 50 or 60 basis points for scheduled premium variable life contracts filed under rule 6e-2 would not be viewed favorably, and if the product was a flexible premium variable life product filed under rule 6e-3(T), they were willing to process registration statements with risk charges up to 90 basis points.

Well, when the industry commented on the 1984 proposal, it raised a lot of objections. It didn't see any sense in this line drawing, and it has always had a problem with the nature of SEC regulation of this charge. The industry position has been that it has been an insurance charge, and the SEC may not even have any jurisdiction over it. The SEC has never bought that argument. They also raised significant concern about this 1933 Act mechanism I mentioned, feeling that it was inappropriate to regulate the 1940 Act issue through prospectus registration processing. This year, when the SEC came out with its reproposed rule, it did attempt to take into account the industry comments. But it conveyed a message, and that is that they will take into account your comments, but there are going to be significant changes in the representations you are going to have to make. You are not going to like them, and we don't like these charges. So what they did was they deleted this 1933 Act mechanism. In other words, they would not have any formal mechanism over which to review these charges, but they changed the nature of the representations that the issuers would have to make. Under this reproposal, they required two representations. First is the one we saw in 1984, namely that the charge be reasonable in relation to the risks assumed. In addition, they required not as an alternative, but as an additional representation, that the charge be designed only to cover the costs of bona fide mortality and administrative expense risks.

When the industry saw this proposal, they understood it to mean that the objective was to assume that an issuer, at the time it sets the level of its risk charge, does not then have a present intention to include an amount that is explicitly intended to pay distribution expenses. Although not clear, some read the proposal to require that a significant portion of what had been denominated a risk charge in existing products would have to be broken out, labelled a sales load, and monitored to ensure compliance with the overall 9% sales load limit of the 1940 Act. Needless to say, companies didn't like this idea, since if their interpretation was correct, neither would feel comfortable making this cost representation, nor would they be able to maintain their current charge structure which could in turn affect the profitability of their products.

Given these serious concerns, industry representatives met with the SEC staff prior to filing a comment letter. They argued that if this was the only alternative that the staff was willing to come up with, 1984 was better than 1987. They filed a comment letter to that effect, and in that letter pointed out a couple of basic premises that I think everyone has always understood. The first being that risk charges have always included an anticipated element of profit. They've never been designed only to cover certain costs, and the idea of a reasonable profit on a risk charge is not something that's anathema to the 1940 Act. Second, this notion of cost really doesn't have any meaning. Who knows what the cost of a risk is in any real sense?

The SEC indicated that they would be receptive to going back to 1984, but the industry would have to eat some crow. In particular, the industry was going to have to give up its objection on this 1933 Act mechanism for reviewing and having a means to prevent contracts with excessive charges from ever being distributed to the public. Second, prospectuses were going to have to be much more detailed in describing the nature of these charges, what they were designed to cover, where the revenues were going, whether the sales loads that were otherwise charged in the contract were going to be sufficient to meet distribution expenses, etc.

Well, what's the current situation? As I mentioned earlier, this rule is still pending. Even though the 1987 version is a reproposal of 1984, we have, for the last six months, been operating still under the 1984 framework. In other words, the staff has not been requiring new registrants to make the representations in the reproposed rule. They have been allowing registrants to continue to make one of the two representations in the 1984 proposal. That means that the 60, 90, and 125-basis point limits are still being enforced by the staff. They will not permit a registration statement to become effective without a lengthy administrative hearing, if the registration has charges in excess of those amounts. The staff is currently targeting the first quarter of next year for publishing a final rule in this area. The content of the rule seems fairly well settled, although we can never be sure, but we are fairly optimistic that the rules we've been living under for the last couple of years will remain in effect, and you should assume that the 60, 90, and 125 limits will not change for some time.

Let me next turn to rule 6e-3(T). There has been a lot of activity in the variable life area from the standpoint of registration statements. There are now about 55 companies that have effective variable life registration statements, and the number of new filings made has been increasing with some regularity -- from

13 in 1984, to 53 last year. This year there have been 38 filings so far. The action the SEC took on rule 6e-3(T) was to amend the rule they originally published in 1984. It did so at the the end of March, and the rule became effective on May 8. Most of what is contained in the amended rule was expected because it coincides to informal SEC staff positions, or interpretations advanced in connection with individual registration statements that have been filed in the last 2 years. However, because the scope and nature of the relief provided by the amended rule differs in a number of respects from that explicitly set forth in the 1984 rule, the SEC requested public comment on the revisions before it made this temporary rule a final rule. That comment period ended on July 31.

In looking at this area, I will not go into all of the technical details of rule 6e-3(T), but I do commend to your attention the release that accompanies the adoption of this amended rule. It is 100 pages in length, it is very detailed, very informative, and very instructive in providing interpretative guidance on the nuances of what you can and cannot do in designing a flexible premium variable life product. Before I comment on a couple of areas though that were covered by the amended rule, I would like to move forward and look further down the road to the permanent rule. The release I just mentioned contains some statements on what the staff intends to do when the permanent rule is adopted. After it's finished considering the comments, and it adopts the rule, what it intends to do is give all existing registrants a one-year period to conform their contract designs to the provisions of the permanent rule to the extent their contract design, as now being marketed, does not conform to the provisions of the permanent rule. Any new registration statements filed after the permanent rule becomes effective would have to initially comply with the provisions of the permanent rule.

The release states that there will be a grandfathered provision insofar that any contracts issued under existing registration statements before the end of the one-year period will not need to be modified, so that the amended permanent rule will not apply to issued and outstanding contracts. The staff timetable on 6e-3(T) is a bit more aggressive than on 26a-3. They are now shooting to have this permanent rule published by the end of this year. So any issuers that have contract designs that might not pass muster under the permanent rule need to begin thinking about modifying those designs if they want to continue relying on 6e-3(T) at the beginning of 1989, or late 1988. There are significant product design consequences that flow from the 1940 Act exemptive rule that variable life products rely on. As you probably know, there are two exemptive rules here, rule 6e-2, and rule 6e-3(T). The material differences in my judgment are as follows.

First, under rule 6e-2, as I just outlined, the risk charge can't exceed 60 basis points, in some cases 50. Under rule 6e-3(T), 90 is what the staff is willing to concede. Under rule 6e-2, separate premiums must be charged for substandard coverage, and for incidental benefits. Rule 6e-3(T) does not contain that requirement. Those charges or amounts for those coverages can be deducted periodically from cash value without otherwise affecting the compliance of the product with the sales load limitations under the 1940 Act. And finally, rule 6e-2 requires a minimum death benefit guarantee. Rule 6e-3(T) does not. So there are significant product design ramifications that flow from whichever rule you are able to rely on. The ability to rely on the rule really turns in large measure on whether you've got a flexible premium as contrasted with a scheduled premium product, and it is proposed that some significant changes be made in this area.

The 1984 rule defined a flexible premium product as one that required only that the contract provide for payments which are not fixed by the insurer, both as to timing and amount. That's similar to the definition in the Internal Revenue Code. The amended rule published this year adds an additional requirement to the definition. That new requirement or element is that there be a reasonable expectation that subsequent premiums will be paid. By itself, that representation or that requirement doesn't seem to say a lot, but the release articulates some fairly bright line interpretations which would have consequences for many registrants, particularly those who either are in, or are contemplating getting into the single or high initial premium market. Let me briefly articulate those bright lines.

The release indicates that a contract requiring an initial payment of 100% of the guideline single premium would not be flexible; it would have to rely on rule 6e-2. Similarly, any contract that required more than 80% of the guideline single premium would not, in the terms of the release, be flexible. Only contracts that did not require an initial payment of more than 80% of the guideline, could, under the terms of the release, rely on the rule even though those contracts might permit up to 100% of the guideline single premium. Third, though not explicit in the release, it is clear from reading between the lines that the staff does not view a contract that conditions the payment of any additional premiums over and above the additional premium, on submission of satisfactory evidence of insurability, as a flexible premium contract. In other words, the staff has tied premium flexibility to not only the ability to make additional premiums, but the ability to do so without underwriting. The industry has strenuously in its comment letter objected to this new requirement, viewing it as unnecessary, and the interpretations I have just enunciated as being too restrictive and misguided.

Among other things, the guideline single premium benchmark says absolutely nothing, and makes no sense in the context of the cash value accumulation contract, and this distinction based on whether or not underwriting is required also doesn't seem to be right. Particularly if you look in the single premium market, one can argue that from the standpoint of the insurer, the insurer has to be prepared to accept a premium at any time, even though it may request evidence of insurability and often the amount of evidence it may request may be minimal, and many, if not most insurers are going to remain healthy for some time. Because these interpretations that I have just briefly summarized were first articulated in this 1987 release, the staff here is also being accommodating. Right now it is not enforcing those interpretations on registrants. It's doing it because this is the first time it has articulated those, and because it has in the past, before it articulated those interpretations, permitted registrants to rely on rule 6e-3(T) even though they were requiring 100% of the guideline single premium. The staff has informed registrants that don't meet these interpretations, however, that they need to be on notice, and need to be aware that if the permanent rule contains provisions that are inconsistent with their contract design, they are going to have to amend them. The prognosis on this issue is not very clear. It seems likely that there is going to be some tightening up, and that some of the contracts that are now relying on rule 6e-3(T) will either have to provide more premium flexibility or they will be faced with the choice of conforming their product designs to rule 6e-2.

I want to talk about sales load regulation. As most of you probably know, most of the time on this exemptive rule 6e-3(T) has been spent trying to come up with a framework for regulating sales loads that would permit the kinds of products that companies want to issue. It has been a very long, protracted process, and by and large now the rules are clear. Although they are not the kinds of rules that the companies would like in all cases, they don't come too far off the mark. The guideline annual premium concept for measuring sales load compliance is in the rule, and will remain in the rule. That guideline premium is based on the 1980 Commissioners Standard Ordinary (CSO) Table and 5% interest assumptions. In order to rely on that guideline premium test, issuers cannot require that more than four guideline premiums be paid in the first two years. Perhaps the most complicated area of the rule has been the manner in which sales loads are regulated in connection with increases in benefits. The industry sought the ability to deduct additional sales loads upon increases without necessarily requiring that additional payments be made at the time of an increase. The amended rule does permit sales loads to be deducted upon an increase without payments to be made, but the conditions for deducting those sales loads are complex. I will not go into them in any depth, but you should be aware that the rules are complicated. They call for allocating premiums and cash value between the increase in coverage and the basic coverage, and thus have not only product design consequences, but systems consequences as well. So, if you are thinking about developing a product that is going to take out additional sales load at the time of an increase, you need to look carefully at those rules.

One final point on sales load regulation relates to the effect of decreases. It's not something that the staff or the industry worried much about when the rule was adopted in 1984. But the amended rule does contain some clarifications relating to decreases. It indicates that a decrease is an event that needs to be taken into account in determining how much sales load you can take out. The guideline premium calculation, which is being used to limit the amount of sales load, has to be revised and take into account the decrease. It does not appear, however, that a decrease by itself would trigger a refund of sales loads previously deducted.

I will mention two other points about 6e-3(T). First is the cost of insurance charges. The 1980 CSO is the general limitation on cost of insurance charges on rule 6e-3(T). That was expected. One positive development is that the rule has been modified to explicitly recognize that one can exceed 1980 CSO, not only when substandard risks are involved, but also when contracts are issued on a simplified underwriting basis, or on a guaranteed issue basis. This provision, permitting higher than 1980 CSO cost of insurance, should be particularly important for contracts in the single or high initial premium market, and also would be extremely important for contracts issued in the group market. There is no specified limit in the rule on those charges, although one can anticipate that the SEC staff will, as it processes registration statements in this area, form some opinion about the way in which those charges can be deducted. My own best guess at this point is that they will look to see, and ask questions about, what the company is deducting for its comparable fixed products. If the charge is comparable to what is being charged on a fixed product, they should not raise an objection.

Finally, I want to talk about state regulation relating to variable life. As you undoubtedly know, in 1982 the NAIC amended the variable life model regulation in a manner that would permit the issuance of flexible and single premium variable life contracts. At the time of the 1982 amendments, 27 states had adopted in some form the old model variable life regulation, first promulgated, I believe, in 1973. Between 1982 and 1987, 20 of those 27 states, as well as several other states which had no variable life regulation, have adopted a regulation which conforms in all substantial respects with the 1982 amendments. Seven of the original 27 states have yet to adopt the 1982 amendments. Those are Alaska, Colorado, Maryland, Massachusetts, Michigan, North Carolina and Pennsylvania. Before addressing two or three of those states where there has been some movement, I would like to mention a brief note about California.

California was one of the states that adopted a regulation conforming in large measure to the 1982 model this year. But as most variable life issuers are aware, California is the state that most closely scrutinizes applications for variable life authority. As a result, it has taken a significant amount of time for companies to become approved in California. Based on the information I have, only one variable life authority was granted in 1986, and maybe three or four so far have been granted in 1987. There are probably more than 40 applications for variable life authority backed up in the California Insurance Department.

In an effort to speed up this review process, the Department has developed a certification process for variable life applicants, which consists of 106 detailed questions. Many companies have found this questionnaire particularly troublesome in a number of areas. Basically, the questions require that they be answered in the affirmative, and some of those questions to be answered in the affirmative would require that insurers follow business practices which would be contrary to the standard business practices followed by public mutual funds, and imposed by the SEC. Whether or not the situation is going to improve significantly in California will depend on whether the California Department is willing to accept review procedures for variable insurance products, comparable to those its state corporation department is now applying to public mutual funds.

I have a brief footnote on the states where there have been some developments. First, in March of 1987, the Michigan Department proposed a number of changes to its current variable life regulation. On June 30, it held a hearing at which a number of industry concerns about the amendments were presented. In its initial draft, the Department had failed to eliminate the restrictive lists of prohibited and permissible investments, had retained a limitation on separate account charges for investment advisory fees, and had failed to incorporate a number of necessary provisions in order to design a flexible premium product. A number of changes were made following the June 30 hearing, and so a number of the concerns have been resolved. Nonetheless, there are still a couple of major items remaining in Michigan. The first is that, under the current version they are working with, a minimum death benefit guarantee is required for all variable life contracts for their flexible scheduled premium. Second, there are still some limitations on investments. The ACLI has been in frequent contact with Michigan. It has hoped that these differences and some that I haven't mentioned will be ironed out, but it is possible that there will be a couple of areas where the Michigan regulation will not conform in all respects to the model.

North Carolina has also been active in the last couple of months. It issued a bulletin in June indicating that flexible premium products cannot be issued in North Carolina. In fact, even though it had previously approved flexible premium products, it went so far as to notify existing registrants that they should no longer be selling flexible premium products in North Carolina. The bulletin that they published indicated that if a petition was filed, it would consider adoption of a new, amended regulation. The ACLI has submitted such a petition. Because the Department didn't hear from any domestic companies, it did not react favorably to the petition. The ACLI is remaining in contact with the Department, and at this point, the Department is developing a set of questions to send to the ACLI in its attempt to better understand the workings of the product.

Finally, we may end on a high note. Pennsylvania was operating for the last 2 years with some guidelines. Those guidelines included a number of the changes reflected in the 1982 model, but did not include them all. On October 7, I believe, industry representatives met with the Department to discuss 17 issues of concern to the regulators and the industry. As a result of that meeting, the trade association believes that the Department will propose a new regulation which conforms in all significant respects to the NAIC model.

MR. WILLIAM E. CONNOR: I will talk about three different topics concerning our variable products at the Prudential. First, I will cover our experience in adding a real estate investment option to our variable product. Second, I will briefly review some of the IRS rules on diversification for variable products. Third, I will share some of our recent sales results, and show how variable products have affected the mix of business that we are getting at the Prudential. Finally, I will step outside the Prudential for a moment, and share some information on variable product sales in the industry in general. My first topic has to do with real estate.

In the last few years, it has become increasingly common for variable life or variable annuity contracts to include a general account option as an additional investment option with the variable contract. Under these options, the insurer guarantees a minimum rate of interest and credits additional interest in much the same way as universal life. Fixed rate options are generally not being registered with the SEC under the 1933 Act as securities, nor have the general accounts of the insurers been registered under the 1940 Act. This is quite different from the treatment of the other portions of the variable contracts. Contracts containing both the registered variable portion and an unregistered general account are often known as combination contracts. These combination contracts have replaced previous generations of contracts, where the variable and general account portions have been actually separate contracts. In the last several years, the SEC has allowed both registered and nonregistered portions to be part of the same contract.

As an example of this progression in contract design, when we first introduced universal life and variable universal life in late 1984 and early 1985, the products were virtual clones. The most significant difference was that the universal life contract was entirely in the general account with a guaranteed rate of interest, and the variable universal life contract consisted entirely of variable options. This was the companion contract approach. When we revised these contracts in late 1986, we incorporated the fixed rate option identical to the universal life contract into our variable universal life contract, thus creating the combination contract. We still maintain the universal life contract for those few agents who are not NASD registered and are thus unable to sell the variable product, but we expect that our registered agents will sell only the variable product.

The idea of the companion real estate-only variable annuity was pioneered by Integrated Resources and Merrill Lynch back in the early 1980s. Both companies began issuing real estate-only variable annuities which were registered as securities under the 1933 Act, but whose separate accounts were not registered as investment companies under the 1940 Act. It is very important for a real estate separate account not to be registered under the 1940 Act, because it would be virtually impossible for the account to meet the liquidity and the valuation requirements of the 1940 Act.

Fortunately, it is possible to operate a real estate separate account without being subject to the 1940 Act, provided at least 60% of the account's investments are not in securities as defined in the 1940 Act. As with the general account option, the next logical step in the evolution of the variable contract is to incorporate the companion real estate contract as an integral part of the companion contract. That is exactly what we have done at Pruco Life. We have extended the concept of the combination contract one step further, by making real estate just another investment option.

Under a single variable contract, we now have three components: a fixed rate option, not subject to the 1933 Act or the 1940 Act; a real estate option, subject to the 1933 Act, but not the 1940 Act; and a variety of variable options which are subject to both Acts. The marketing advantages of combination contracts are obvious. The client can invest a portion of the contract's funds in real estate, and the remainder among stocks, bonds, money market options, and even the fixed rate option, for greater diversification without separate contract fees. We believe that real estate is a much more attractive investment option when it can be used for only a portion of the client's funds, rather than when it is an all or nothing choice. We've also made real estate available as an investment option under a life insurance contract for the first time. Finally, by making real estate available on a broad range of variable contracts, we believe it is much easier to generate the large amounts of money which will be necessary to enable us to operate the account efficiently. Other than the significant regulatory concerns, there are two practical issues that need to be addressed in regard to real estate -- valuation and liquidity.

The valuation question is, How often will you calculate unit values for the account? The liquidity question is, How will requests for redemptions be handled? For our account, we calculate daily unit values. To calculate these values, we have each property appraised once a year by an independent appraiser. Between outside appraisals, our real estate department adjusts the value of the property quarterly, based on its own internal review. Initially, we plan to do this internal review monthly until we get a larger number of properties. We can adjust the value of the property at other times if any material information becomes available. Since we intend to invest primarily in income-producing real estate, not development projects, the periodic revaluations should result in relatively small changes in the unit value. This is because we expect the primary source of return to be the income on the property, not the appreciation. As I mentioned previously, the more significant portion should be the income portion. We make an estimate each year of the anticipated net operating income from each property. This estimated net operating income is then accrued daily with a monthly true-up to reflect any difference between actual and estimated. The daily estimated net income is used to calculate the daily unit value. Establishing the accounting procedures for real estate was one of the most difficult aspects of this project.

We handled the liquidity problem in a number of ways. Transfers out of the account are limited. They are permitted only once a year on contract anniversaries, and are subject to certain other limitations. This is similar to the treatment you find in many fixed rate options. We also maintain about 10% - 15% of the accounts' assets in liquid securities to handle variations of actual cash flow from expected cash flows. Finally, by investing in income producing properties and mortgages, rather than development properties, we get a continuing stream of investment income in the account. This helps our liquidity position.

Another important consideration is the seed money needed for the real estate separate account. We have authorization for Prudential to invest up to $100 million as properties become available to help establish the account. We felt this was the minimum we needed to establish a well diversified portfolio. In addition to the IRS diversification requirements, which require at least five different investments by the end of the start-up period, there are obvious investment benefits to having a portfolio with real estate, diversified by type and geographical location.

My second topic is to very briefly discuss the IRS rules on diversifications, and point out some of the implications of these rules for product design. Section 817 of the Tax Reform Act of 1984 codified the Treasury's right to prescribe diversification regulations for variable contracts. Proposed and temporary regulations under diversification were finally issued on September 15 last year. The following are, I believe, the major implications of these regulations for variable contract design:

1. Probably the most important thing is that you need to make sure that you are aware of the rules, and have established a means of monitoring compliance with them. Penalties for failure are severe. All gains in the contract today are immediately taxable to the owner, and the contract is permanently disqualified so all future gains are taxable.

2. On the positive side, the rules are generally more liberal than recent IRS positions. For example, you need 5 distinct investments in order to have a diversified portfolio, and there is a special rule for variable life that can be even more liberal. Basically, you can have no more than 55% in any one investment, 70% in any two investments, 80% in any three investments, or 90% in any four investments. Concerning permissible investment options, the rules prohibit a government securities fund essentially, since all government securities are treated as a single investment. Highly specialized funds would also be prohibited.

A final point is that unfortunately the regulations are not the final word on permissible variable contract investments. The final paragraph of the explanation which accompanies the regulations made this quite clear. Here is an excerpt: "The regulations do not address any issues other than diversification standards, in particular, they do not provide guidance concerning the circumstances in which investor control of investments may cause the investor rather than the insurance company to be treated as the owner of the assets." Based on previous comments by Treasury officials, we believe the IRS would be concerned if policyholders could invest in subaccounts targeted to very specific types of investments, such as oil or automobile stocks.

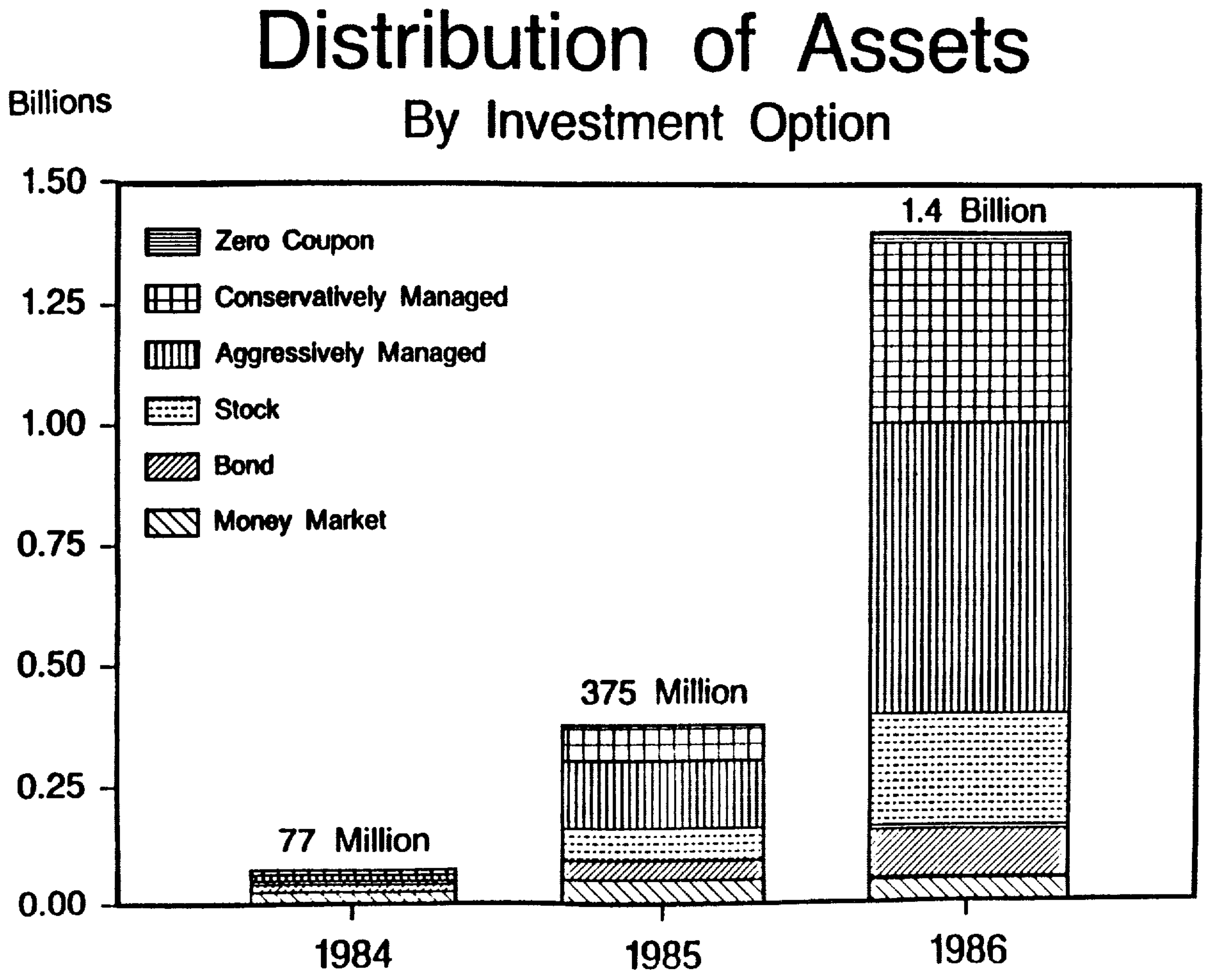
My third topic will be to discuss how variable products have changed the mix of business at the Prudential in recent years. In case you don't know, our sales results with our flexible premium variable life policy, which we call variable appreciable life, or VAL, have been spectacular. It has been successful beyond our most optimistic projections. In 1986, we sold $190 million of scheduled premium, plus we had an additional $230 million of first year drop-ins, and we are on track to sell a lot more in 1987. Our VAL policy is currently outselling, in terms of scheduled premiums, all traditional permanent policies combined. Now, I'd like to take you through and look at how the composition of our business has changed since we introduced VAL two and half years ago; in particular, how our mix of investment options has changed.

When we introduced VAL in the beginning of 1985, we had a fixed premium variable life policy, and a flexible variable annuity, both of which were introduced in mid-1983. After a year and a half of sales, total separate account assets for these two individual variable products stood at an unexciting $77 million.

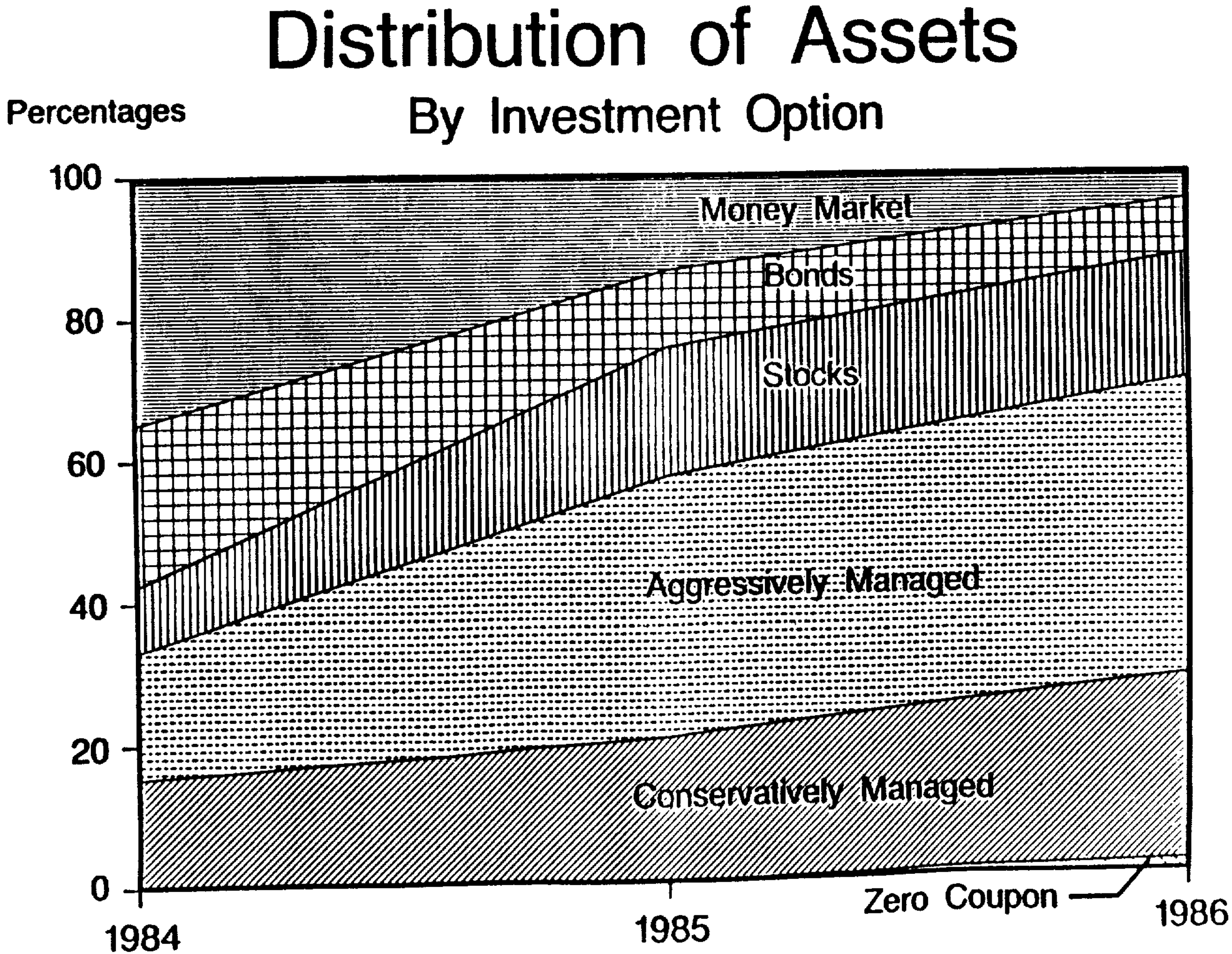
Graph 1 shows how our individual variable assets have grown since we introduced VAL. As of the end of 1986, variable contract assets had jumped to $1.4 billion, and roughly half of that was from our previously unexciting variable annuity. Halfway through 1987, variable assets stood at $2.4 billion. This graph also shows how our clients have chosen to invest this money.

To make this a little clearer, Graph 2 shows the breakdown of assets by investment choice in percentage terms. Back in 1984, our most popular investment option was the money market option, with over one-third of all assets. Another third was split between our two managed options, conservatively and aggressively managed. In these options, the Prudential selects the mix of money-market

GRAPH 1


Distribution of Assets
By Investment Option
Billions
1.50
1.25
1.00
0.75
0.50
0.25
0.00
Zero Coupon
Conservatively Managed
Aggressively Managed
Stock
Bond
Money Market
77 Million
375 Million
1.4 Billion
1984
1985
1986

GRAPH 2


Distribution of Assets
By Investment Option
Percentages
100
80
60
40
20
0
1984
1985
1986
Money Market
Bonds
Stocks
Aggressively Managed
Conservatively Managed
Zero Coupon

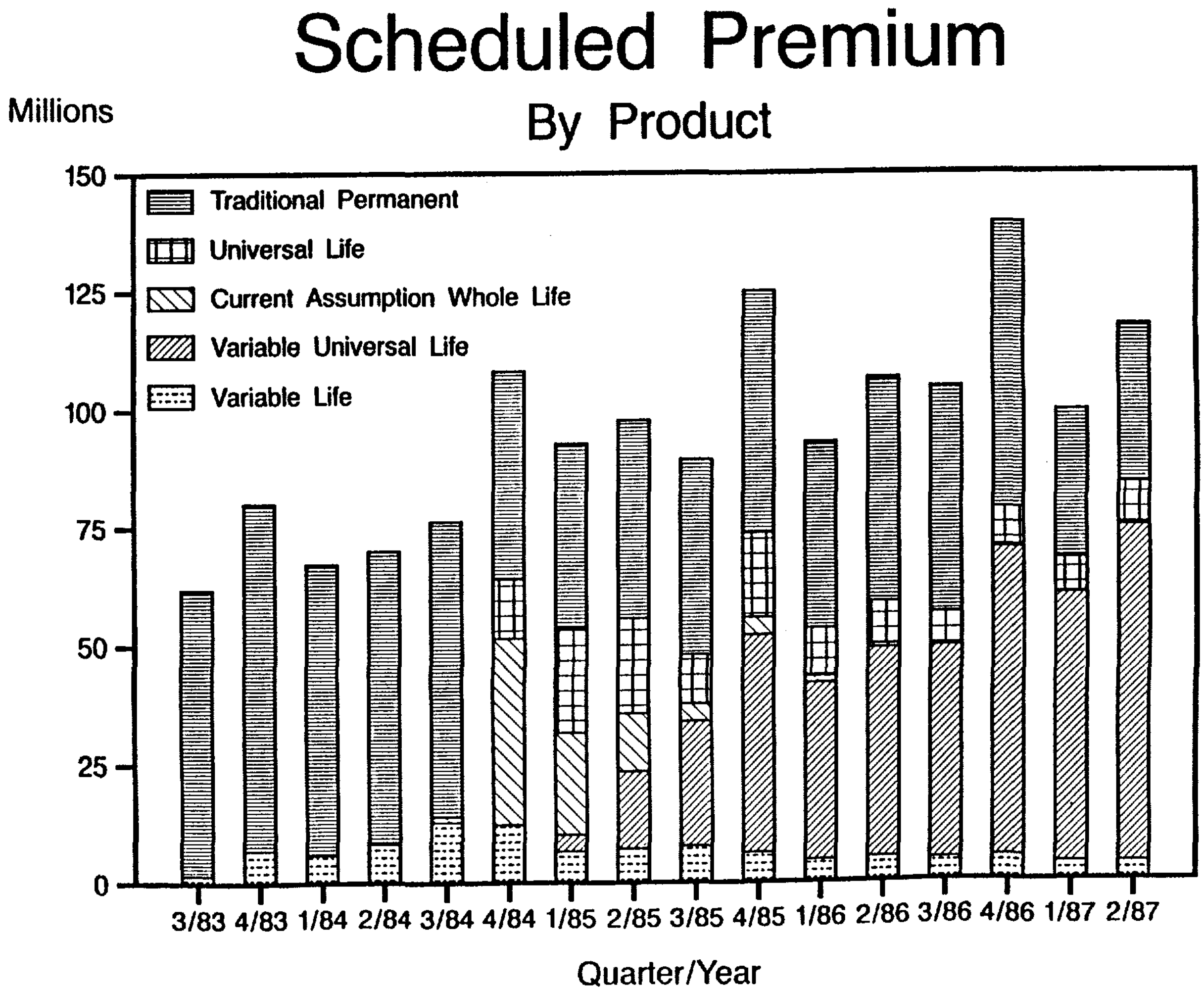
funds, stocks and bonds that it believes to be appropriate, based on its economic outlook. Less than 10% of assets were in stocks back in 1984.

Two years later, the distribution was significantly different. At the end of 1986, we had less than 5% in the money market, about 20% in stocks, and approximately 70% in our two managed options. Our most popular was then, and remains now, the aggressively managed option with over 40%. The growth in the stock and managed portfolios has been primarily at the expense of money-market funds and to a lesser extent bonds. So far most agents and clients do not seem to want to be bothered choosing their investment options, but rather are willing to let the Prudential choose for them. The move out of the money market and into stocks, and the aggressively managed option also shows a greater willingness of agents to recommend, and clients to choose riskier investments. (I have written here that so far the stock market rally has rewarded this approach. That may not be true at this hour.) We believe that the move to riskier investment choices reflects a greater level of comfort on the part of our agents with investments that can go down as well as up. I have heard many companies say that their producers prefer selling guarantees to variable products. Ours did too. These attitudes take time to change, but it can be done, and if you do change that attitude in your field force, there can be enormous rewards as the following several graphs show.

Graph 3 shows quarterly life insurance sales results for the Prudential since we introduced our plain vanilla variable life in mid-1983. The graph shows scheduled premium sold for permanent policies of $25,000 or more. It illustrates how our mix of business has changed as we have introduced several nontraditional investment-oriented contracts. It is obviously a seasonal trend. The fourth quarter is the largest, but you can see that the overall year-to-year trend is up, and while we are selling less traditional life insurance, our total sales are going up significantly as a result of the enormous growth of nontraditional sales.

Graph 4 is a little more informative since it shows how the total pie is split up by product. The fixed premium variable life started slowly, and eventually grew to over 15% of sales after a year. In the third quarter of 1984, we introduced a current assumption whole life contract with a 12% crediting rate. It quickly became a very big seller. Three months later, we introduced our universal life, and it quickly cut into sales with the current assumption whole life policy.

GRAPH 3

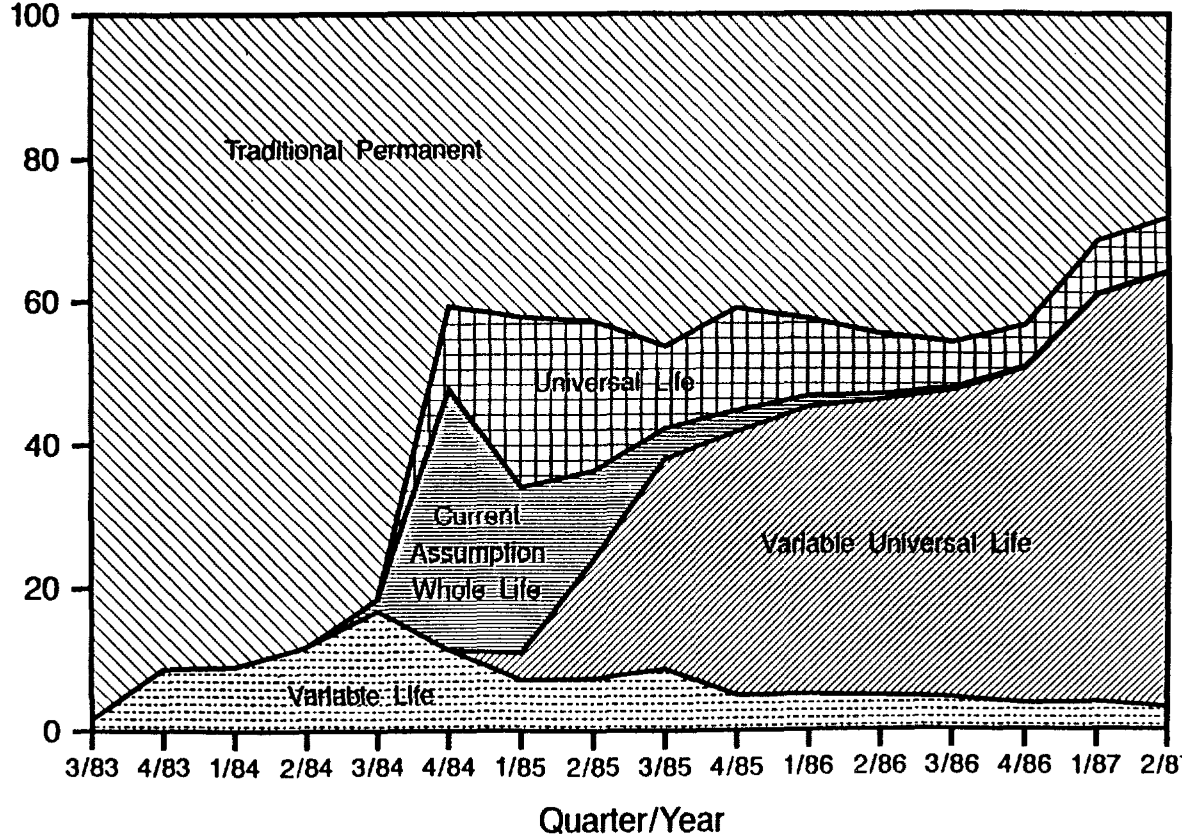

Scheduled Premium
By Product
Millions
150
125
100
75
50
25
0
Traditional Permanent
Universal Life
Current Assumption Whole Life
Variable Universal Life
Variable Life
3/83 4/83 1/84 2/84 3/84 4/84 1/85 2/85 3/85 4/85 1/86 2/86 3/86 4/86 1/87 2/87
Quarter/Year

GRAPH 4

Scheduled Premium

By Product

Percentages



Finally, in the first quarter of 1985, we introduced VAL. Sales grew rapidly as we added key approvals in key states. The percentage of business in variable universal life continued to grow in 1986 and 1987, although at a somewhat slower rate. Although permanent life insurance, both fixed and variable, remains the primary product for our field force, there is another growing piece of our agent-sold business, which I will call a savings market.

As our agents became comfortable selling variable products generally, and had enormous sales success with variable universal life in particular, we had an even bigger explosion in the sales of our savings products. By savings products I mean low-load accumulation-type products, namely annuities, single-pay life, first-year drop-ins on flexible premium life products, and mutual funds. The graphs that follow include sales of all these products by our agents, and also include sales of all these products except mutual funds by stockbrokers with whom we have marketing agreements. Fixed dollar annuities were the traditional savings products sold by insurance companies in the past. This has changed dramatically at the Prudential in the last few years. As Graph 5 shows, mutual funds have grown to become a dominant product in this market. The new kid on the block, life insurance, is starting to grow rapidly, and so far this year, life insurance has surpassed annuities in terms of new savings dollars.

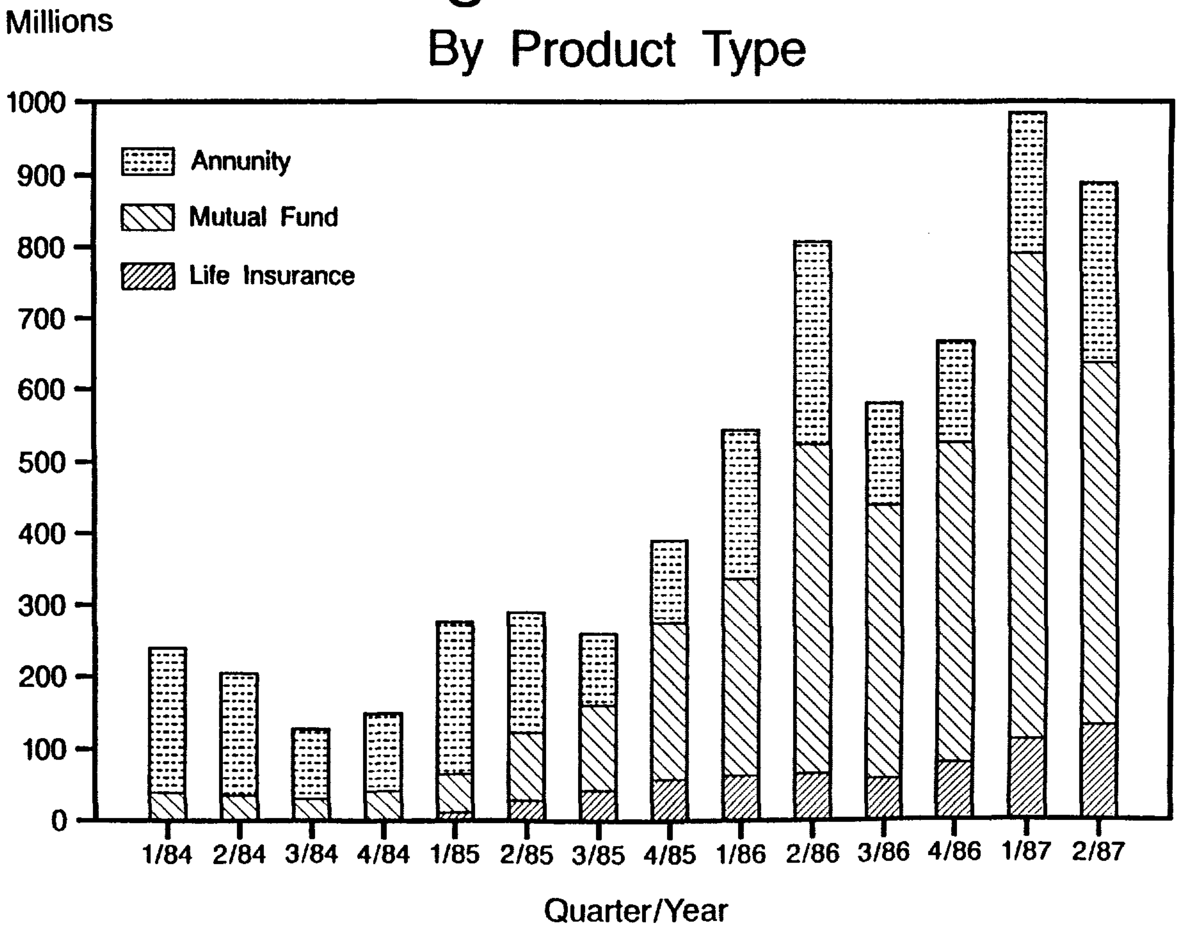
Graph 6 shows how the savings market is split up percentagewise between annuities, mutual funds and life insurance. From the beginning of 1984 to the middle of 1987, mutual funds have grown from about 20% to about 50% of savings products sales, and life insurance has grown from nothing to about 25% of such sales.

Finally, I think the next two graphs (Graphs 7 and 8) tell the most interesting story with regard to how variable products have affected our savings business. These graphs show how our savings business is split between registered and nonregistered products. As I mentioned earlier, when we introduced variable life in 1983, it took a massive effort to get our agents licensed to sell registered products, and a continuing training effort to promote the sale of registered products. Well, once our agents began selling variable products, sales of other registered products grew also, and when our agents got excited about variable universal life, sales of other registered products really took off. From less than 20% of savings products in the beginning of 1984, over 90% of current product

GRAPH 5

Single Premium

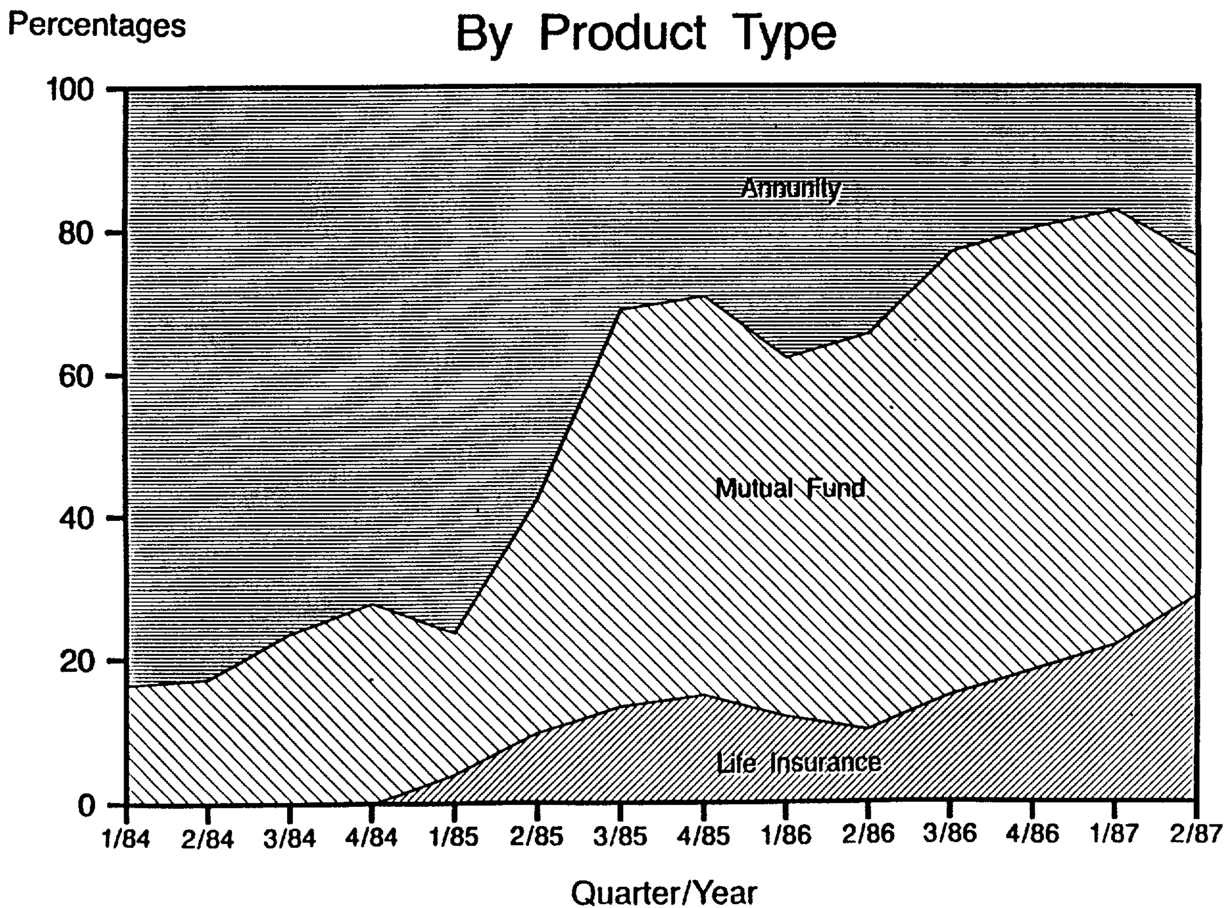
By Product Type



GRAPH 6

Single Premium

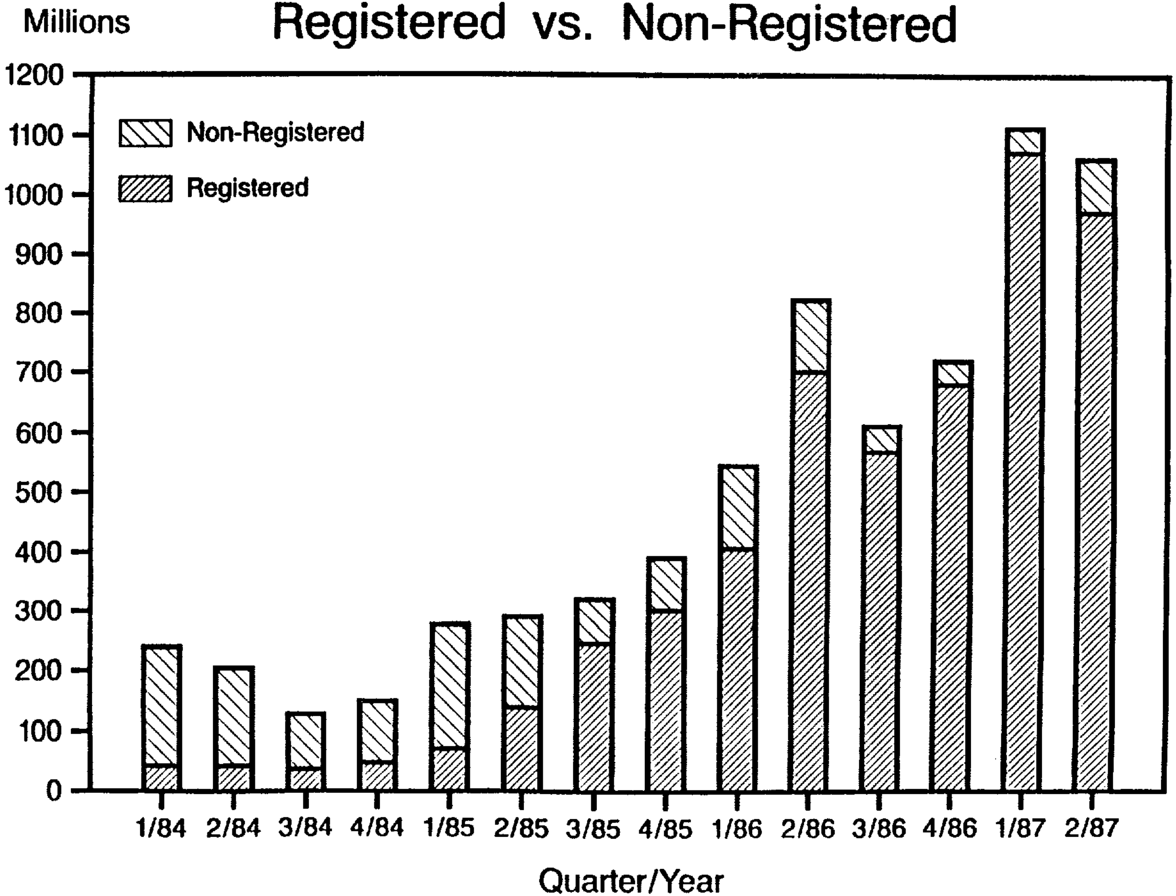
By Product Type



GRAPH 7

Single Premium

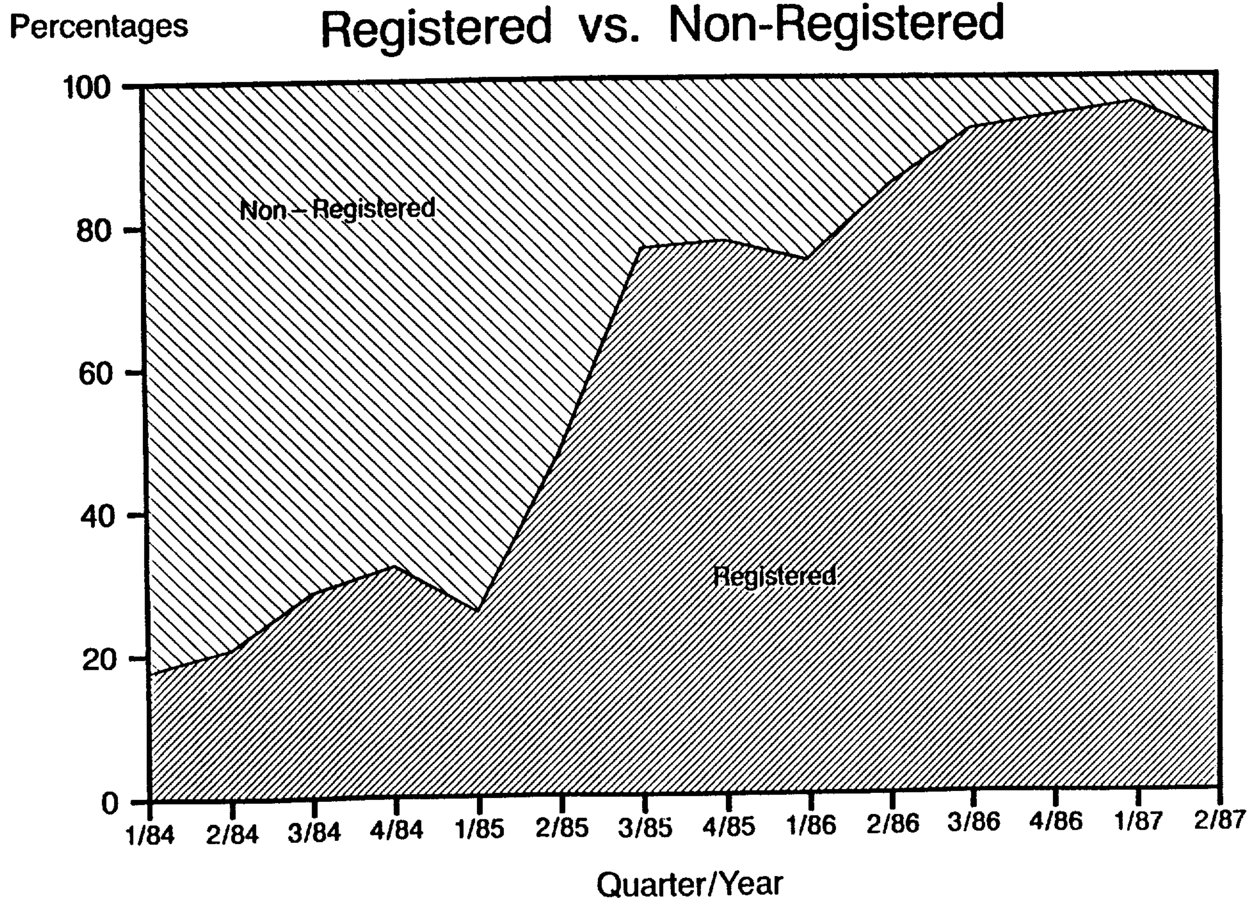
Registered vs. Non-Registered



GRAPH 8

Single Premium

Registered vs. Non-Registered



sales are now registered products. For our agents, an NASD license has become almost as essential as a life insurance license. As you can see, the Prudential has made a big commitment to the registered product market and has had a lot of success there. We believe variable products are here to stay, and we think they are the products of the future. So far, our agents are proving us right.

Now I would like to conclude my portion of this presentation by sharing very briefly some information with you on variable product sales for the industry in general. First, let us look at what is occurring in the annuity marketplace. Life Insurance Marketing and Research Association (LIMRA) reported that in the first half of 1987, individual annuity considerations exceeded $5.6 billion. The LIMRA survey included considerations for individual annuities from 31 major companies. The $5.6 billion is truly a total number. It includes fixed and variable, qualified and nonqualified. All results are for the most part up across the board. Let us look at some of the components. Qualified results, which represented $4 billion of the $5.6 billion, were up 21%, nonqualified results experienced a 28% increase. The widest variation in results jumps out at you if you look at the fixed-variable split. Fixed annuities continue to represent the larger portion. Fixed results were up over $450 million to nearly $3.6 billion, an increase of 15%, but the overall increase in annuity results was really fueled by a significant increase in variable sales. Variable results were up over $600 million to over $2 billion, an impressive 41% growth rate. This stellar performance caused the variable portion of the annuity pie to jump from 32% to 37%.

Now let's look at the present status of the life insurance marketplace. Through July, the annualized premiums for variable life contracts were up over 94% for the comparable period last year. For the same seven-month period, variable universal life annualized premiums were up 227% over 1986 results. These gains in variable life and variable universal life sales have been at the expense of sales of term insurance, universal life insurance, and current assumption whole life, all of which experienced a decrease in annualized premium. Probably the hottest topic in the insurance arena today is single premium life insurance. It may be of some value to look at single premium results separately from annualized premium results. For the first half of 1986, single premium results were $943 million, while annualized premiums from other products were $2.7 billion. The calendar now says 1987, and shows us a very much different situation.

Through June of 1987, single premium results were nearly $3.4 billion, up 259%, while annualized premium results from other products had grown only to $2.8 billion, up 4%. How much of this explosive growth is due to variable sales? The answer seems to be that variable sales are carrying their own weight. A telephone survey of the key variable life players reveals that single premium variable life sales have exploded from just over $100 million in 1983, to over $500 million in 1985, to $1.4 billion in 1986, to about $1.6 billion in the first six months of 1987 alone. I believe it is clear, as is the case with annualized premium business, that variable life is proving to be a home run in the single premium life business.

MR. RODNEY R. ROHDA: Surprising as it may seem, my first concurrent session appearance on the subject of variable life happened in Seattle, Washington, in 1971, sixteen years ago. Some of you were still in grade school, I believe, at that time. A lot more of you were not even in the industry yet. A reading of that yellow transcript from the concurrent session back in 1971 would lead you to believe that we as panelists thought that the industry was at the dawn of a whole new world with regard to life insurance. We might have been at that dawn, but the sun has been very, very slow in arising. The variable life insurance landmark paper written by the New York Life actuaries had come out in 1969. In 1971, when we made that first presentation, there were no U.S. companies that were selling variable life, but a number were trying very hard at that time to get into the marketplace. But as you have seen on those graphs from Bill Connor, variable life is alive and well today at Prudential, and at a number of other companies within the industry. I think we can get a better appreciation for what is happening with variable life, if we compare and contrast situations today with what they were fifteen years ago. I would like to do that comparison looking at four different elements: the product, the economy, the consumer, and the insurer's financial condition.

First, there is the product. Many of you probably do not recognize that that first variable life design back in the sixties and early seventies offered only a common stock option. We think we are anxious right now about the Dow Jones; just think about it back then when common stock was the only option in that product. Furthermore, there was no particular attention paid at that time with regard to a specifically, finely tuned investment philosophy for that common stock portfolio. It was a somewhat generic common stock growth portfolio. The economy back then had enjoyed an extremely long period of stable interest rates, difficult as you might find this to believe. That was back in those days when a 25-basis point swing in bond yields merited headlines, and the stock prices had experienced a long-term bull market, and in fact those years were characterized as the go-go years. At Society meetings the phrase "greed not need" was used to describe what the obvious appeal of variable life insurance was going to be, and in fact the suggestion was that variable life was going to be the go-go product of the insurance industry. Quite obviously, we all discovered to go-go, meaning it went, and in fact after last week's record drop in the Dow, at 235 points, it tends to make a lot of us reflect back on those years and what happened last time, and see what carryover it could have this time.

It is also, I think, important to point out that much of the variable life work that got done fifteen years ago, and specifically between the period of 1970 and 1974, when much product design was done, covered two recession years, and during that period the Dow Jones Industrial Average really moved sideways. If you adjust it for inflation for that period, in fact it went down. Actually, if you look at the Dow Jones for the entire period of the 1970s and adjust it for inflation, you discover that the trend was down. So we really should not be surprised with what happened to variable life in round one. In addition, the consumer in the late sixties and early seventies was relatively naive with regard to his or her financial options, and the trade-off between them. Life insurance companies in the late sixties and early seventies had enjoyed a relative period of substantial profitability. It might not have seemed like it then, but as we look back today, those were the good old days of profitability for many companies.

Let us turn now to a present day analysis of the four factors which I have identified: the economy, the consumer, the product design, and the insurer's financial condition. Our work on variable life today takes place against a backdrop, to say the least, of an extremely volatile economy, and volatile I might add for basically the last ten years. Interest rates and stock prices have moved dramatically in both directions. The financial security of a few surprisingly major financial concerns have been put into jeopardy. There has been a literal explosion in the variety and in the sophistication of today's financial instruments. Not surprisingly, consumers have become increasingly more sophisticated.

Ten to fifteen years ago, a tough consumer financial decision centered on choosing between a free picnic cooler and a toaster at the local bank. But today, it is not impossible to overhear a shopper at K-Mart discussing the trade-off between yield, risk and maturity dates. It is natural then that variable life policies today offer a variety of investment options compared to that lone common stock option of fifteen years ago, and Bill, I think you explained that very, very well in your remarks. Also, as Mary Ann Brown discussed, those options today are just not your generic stock, bond, and money market options. In fact, in each of those three there are subdivisions, long-term bonds, junk bonds, and so on and so forth on through them. Bill Connor talked about a real estate option. I personally would not be too surprised to see variations on the single real estate theme coming through in future products.

What about life insurance companies today? Well, if the phrase *comfortable profitability* is an apt characterization of the late sixties and early seventies, then the words *declining margins* and *increasing strains of all type* are true today. Just within the past two weeks, we have read about two major companies, Continental and Travelers, exploring the possibility of selling life insurance subsidiaries because of their declining profitability, and the need to redeploy capital elsewhere in more potentially lucrative ventures. The basic message is that the insurance marketplace of 1987 is a considerably different one than it was fifteen years ago. Variable life was a dud then, and I believe is a rising star today. It has the ingredients which offer a win-win situation for the consumer, as well as for the insurer. It provides investment choices, and the flexibility needed for the consumer. It offers the chance to get away from the consumers' complaints that they neither understand nor particularly like what the insurer is doing with their money.

From the insurer's standpoint, it for once offers the opportunity to match assets and liabilities. I think this was succinctly stated by Jim Anderson in May 1985 at a Tillinghast/Life Office Management Association (LOMA) variable universal life seminar, and I must add that I don't want to take a page from the Joe Biden book on power speeches, and I want to be very careful about documenting this quote. Jim, at that seminar, said, "It is very difficult, arguably impossible, to design saleable products of a guaranteed nature where the assets and liabilities match. Properly, the only true match is cash, and the chances are that a cash-linked product over long periods of time would be unsaleable. Variable life is a win-win for the consumer and the insurer, and by definition this should make the agent a winner, too."

I will take this point further and suggest that there will be a fourth winner, thanks to variable life, and that is the insurance industry. The September 28, 1987 edition of the *National Underwriter* carried an editorial titled, "A Shifting Perspective." The editorial quotes Gilbert MacLean of their sister publication, the *Ohio Underwriter.* In part he states: ". . . fifteen years ago when the consumer saw the life business as his savings protection business, for every new premium dollar assimilated by the life insurance business, the mutual fund industry took in 20% in new revenues. Yet, for every dollar of new life premium, the mutual fund industry took in 20%." MacLean goes on to state that today the picture has changed dramatically. For every new dollar of life insurance generated in 1986, the mutual fund industry generated $15, a 75-fold turnaround in those past fifteen years. The editorial documents the substantial premium growth in 1987 which Bill Connor again talked about, and points out that that growth came primarily from interest-sensitive and variable single premium business, and also suggests that this could be one of the reasons why the mutual fund industry in 1987 expects a slight drop following its blistering growth from 1984 to 1986.

I believe that variable life and annuity products offer the opportunity for real growth in the life insurance industry, which is a much needed change in the erosion we suffered over the last decade and a half. But it is very important to add a caution that this growth will be sustainable only if we succeed in helping consumers to understand exactly what they are buying, and only if we, as an industry, focus on the unique features available only from our products.

Pete Stark's new release which accompanied his HR #3441 introduced in the House last week, opened with the following paragraph: "Reform is needed in the tax treatment of life insurance policies . . . ." He also said: "The purpose of life insurance is being distorted from providing money to widows and orphans to financing fast cars and exotic vacations." We brought this on ourselves and can hope to conserve our current tax treatment only if we are equally clear about those things that we are, as well as those things that we are not.

Now for a few words about my current career challenge. As Mary Ann said in her introduction, I joined Fidelity Investments this past March with the goal of building a life insurance company from scratch. Fidelity Investments has over $80 billion under management today. I use the words over $80 billion because if you try to nail it exactly, it tends to vary a billion or two each day as the market changes right now, and it offers more than a hundred different mutual funds. Approximately two million households in the United States have accounts with Fidelity. It is probably best known for its Magellan Fund, which today exceeds $10 billion in assets under management, and it has one of the best long-term growth records in the industry. Today Fidelity has more than 7,000 employees nationwide. It is targeted towards the upscale, typically urban client that seeks only information regarding his or her investment decisions, the financial planning do-it-yourselfer. And I should add here that our market research suggests that for those of you over age 40, Fidelity most likely has between an 8% and a 12% market share in you as an upscale professional group.

Fidelity purchased Provident Mutual's variable life subsidiary at the end of 1986, and as Mary Ann mentioned before, we are now in the rather frantic process of developing variable life and variable annuity contracts which we hope to begin marketing on a direct basis in the first quarter of 1988. If we achieve that, we would be going from dead start to a product in the marketplace, a variable product, in twelve months. I would like to share our experience in choosing a variable product computer system with you.

First, if you are not familiar with the term *vaporware*, you should become so before venturing out into the variable product software marketplace. Just this past spring, we shopped in this marketplace for a system which would handle all processing elements of our two relatively simple variable products that we were then designing. We wanted to concentrate our attention on those systems that were currently operational, that had additional features such as a proposal system integrated with them, that could be run by a Third Party Administrator for the first year or two, and then migrated into Fidelity's fairly sophisticated in-house hardware. Ideally, we wanted a system that had a number of happy users in place, ready to tell how pleased they were with what they bought. We in fact discovered that there was not a single system out there that meets these specifications. But to say the least, vendors are working frantically to fill this void. I strongly urge you, whether your role in your companies or consulting work is in product development, or in financial analysis, or in general management, to make sure that you are directly tuned in if you are going to be out selecting a variable product software system. Systems are never cheap, nor simple, nor on time. The complexity of variable products coupled with premium flexibilities add some new factors to that already complex systems formula.

Now, in closing, let me just take that word *complex* because I think the word is an appropriate one to describe variable life, as it relates to what Mary Ann Brown and Steve Roth said with regard to regulation, or as it relates to what Bill Connor talked about with regard to the variety of separate account options and product designs. But today we are in fact in a complex world and though the Dow Jones might currently be in a state of free fall, I think that variable life in its complex design in fact answers a number of product as well as industry needs. I for one feel that if I am back up in a concurrent session fifteen years from now, that we are not going to look back to another state of slow growth for variable life, but rather we will be able to look back then and realize that in 1987 variable life was ready to take its place in the insurance industry as a very viable and healthy product.

MR. WALTER N. MILLER: I am an old dog in the variable life business and certainly joining those on the panel in believing that perhaps at last it is a product with a bright future. It strikes me that two of the really most important elements for success in this business are probably ones that don't have a lot to do with traditional actuarial concepts and traditional actuarial work. One is marketing strategy and implementation, and the other is investment performance. If you were trying to enter or succeed in a variable life business, without making the strongest possible effort that you can to get your entire field force licensed, you are just doing something that is cost ineffective. It's going to cost you a wad of resources to get into the business in the first place, and if at the same time you are not trying to gear up your entire marketing plant to capitalize on the sales potential of what you are doing, I would submit you are making a pretty big mistake. I think probably Bill would agree that one of the biggest parts of Prudential's obvious success was our success, and it took hard work and more resource expenditure than we thought at the beginning to get where we are in licensing.

We have announced, by the way, that beginning next spring we are going to require NASD licensing as a precondition for hiring a brand new agent in the first place. The other part of the marketing strategy is doing the best you can in all of your training and promotion with your agents to emphasize need over greed. Anybody in the business is going to have an interesting education sometime over the next 12 months, or 18 months, or perhaps tomorrow, on selling variable life, or keeping it on the books in a down market. A lot of the business has been sold by the glamour of the 12% illustration, and mountain charts and all that. We are not going to keep that very long, and we may not keep many of those customers. Other business that has been sold by first demonstrating the need for life insurance, and then explaining why variable life is a flexible way of meeting that need, or giving the opportunity to meet that need better, will fare better.

The second point is on investment performance. I can just recall the days of the early seventies when there were all sorts of panels on variable life, and it was supposed to be the brightest, most exciting thing, and we were all arguing over this, that or the other product design. One of the important players in this turned to me one day on a panel and said that this was all going to amount to nothing. The companies with the good investment track records are going to be the winners, and there is a lot to that.

MS. BROWN: Walt, those are some excellent points. I would like to add to the marketing point that in addition to the training, I think you have to pay at least the same commissions on your variable products as you do on your comparable fixed products.

MR. JAMES F. BUSS: I wanted to ask Steve Roth if he thought the permanent rule would allow for average premium tax deductions, or whether he thought we will move towards actual state premium tax.

MR. ROTH: The references to rule 6e-3(T), the release accompanying the rule, requested comment on whether premium taxes should be deducted on an average basis as has been the practice with virtually all companies, or whether it should be required to deduct it on a state-by-state basis as is commonly done in the variable annuity area. The staff was obviously pondering that when the industry objected to requiring a state-by-state basis, arguing that there is really not a lot of benefit to be gotten. The staff's concern was that there was too much variation in premium taxes from state to state, and it is just fair to require the purchaser to pay based on the state of residence. Currently, the staff is taking a position that would permit either. The only thing they are prohibiting is sort of a hybrid, where you charge an average tax, but in those jurisdictions such as in Kentucky where there is an exorbitant tax, you charge an extra amount. The sense we have gotten is they will probably allow the continuation of the average, but it is going to have to be averaged for everybody. If you are not willing to eat the difference in jurisdictions where there are exorbitantly high taxes, you just won't be able to sell there.

MR. BARRY L. SHEMIN: I have a question for Bill Connor relating to the fixed interest accounts that are becoming popular. It's common to include some restrictions in these accounts out of fear of investment antiselection, and I wonder if you could comment, first of all, on whether your graph showing the mix of investments would look very different if you included the amounts that are in the fixed interest account, and second, on whether or not the restrictions that companies have typically included have much of an effect on the options chosen by buyers.

MR. CONNOR: That's a very good question. It is a little bit difficult to answer. The fixed account in most of our products has been available for a relatively limited period of time. For example, for VAL, the fixed account was introduced in September of 1986. Our single pay life product came out earlier in 1986 and also had a fixed account. It is really too early to see what effect the limitations on transfers out of the fixed account have had, primarily because you only see transfers out of the fixed account on the anniversary. We have had relatively little measurable transfer of business out of the fixed account. We have also had relatively little measurable negative feedback, or negative reaction, if you will, to the limitations, so it is a little bit difficult to respond to how effective they have been. We believe that they are reasonable precautions which should be included in a fixed rate option, if you were to include it within a variable product.

I think I went to the second part of your question first, and I believe the first part was whether the graphs which I have used would be markedly different if we included the fixed rate option. I will answer that very briefly. They would be little different, very little different.