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CURRENT TOPICS FOR INDIVIDUAL LIFE AND ANNUITY PRODUCT DEVELOPMENT

Moderator: WALTER N. MILLER
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Recorder: RICHARD K. WONG

- Illustration credibility
- Single premium life taxation
- Dividends
- Long-term care riders (accelerated death benefits)
- Group Universal Life Plans (GULP)
- Leveraged Corporate Owned Life Insurance (COLI)

MR. WALTER N. MILLER: At the panel discussion, "Are Current Product Illustrations Supportable?", Robert Greving gave one of the best statements I've ever heard on this subject. Nonsupportable product illustrations create a clash of responsibilities to our company (and client companies for consultants), agents, potential policyholders, regulatory authorities, our profession and industry and, lastly, ourselves. [Mr. Miller read highlights of Mr. Greving's talk which is contained, in full, on pp. 757-75 in this issue of the *Record*.]

MR. HAROLD G. INGRAHAM JR.: There's been no shortage of proposals pending before Congress about the investment war and alleged tax avoidance abuses of single premium life insurance products. The government wants to raise between $20 billion and $60 billion of new revenue and the life insurance industry is apparently being targeted for about one-third of this budget increase. So the issue for the industry is one of damage control at best. There's no question that Congress, on some basis, is going to zap single premium life policies, whether they be single premium whole life, single premium universal life, or single premium variable life. They regard these policies as essentially tax shelters supported by small death benefits. And the key issue is the relationship of death benefits to cash values which inexorably leads you to reconsider the definitions of life insurance in Section 7702 of the Internal Revenue Code.

Chairman Rostenkowski of the House Ways and Means Committee is personally interested in this issue. He's convinced that single premium life policies represent tax shelters contrary to the spirit of the Tax Reform Act of 1986.

The polar extremes of dealing with the single premium issues have been characterized as the "distribution" approach and the "definitional" approach. The distribution approach embodied in the Stark-Gradison Bill would apply annuity-type taxation to all distributions, including policy loans, from all life insurance contracts. The definitional approach advocated by the National Association of Life Underwriters (NALU) would deny life insurance status to any contract which is funded more rapidly than a level premium five-pay standard. The American Council of Life Insurance (ACLI) has recently stitched together a compromise

proposal apparently acceptable to the NALU, the Association for Advanced Life Underwriting (AALU) and the National Association of Life Companies (NALC). This compromise wouldn't change the definition of life insurance in Section 7702. Instead, it alters the tax on distributions in Section 72 and, in so doing, defines a class of contracts called modified endowments. These are contracts under which total premiums paid at any time during the first 5 policy years exceed the sum of five-pay net level premiums for a contract with the same benefits. The five-pay net level premiums would be calculated using interest of at least 4% and mortality guarantees, but they would ignore expenses. Once these modified endowments pass the first 10 policy years, current tax treatment would apply to future distributions.

I understand this compromise proposal has been ratified by the ACLI's Tax Steering Committee and it has been taken to Capitol Hill this past week by Messrs. Schweiker and Minck of the ACLI and a member of the NALU. The feeling was to get a proposal in Congress's hands before a more draconian one gets to them from Treasury staff.

The House Ways and Means Committee is expected to act first on single premium life as part of a technical corrections bill markup that would take place some time in the next few weeks. A tough fight lies ahead for the life insurance industry on the effective date of any new tax on single premium life distributions. I guess the conflict is over new money as proposed by Representative Stark versus new policies as proposed by the life insurance industry. Any grandfathering is definitely problematic at this point.

MR. MILLER: I would just like to add one footnote. You cannot underestimate the importance of Harold's last comment on the possible new way of grandfathering. Previously, in-force policies were either grandfathered or not when there was a change in the tax law. This new concept of grandfathering what is already in in-force contracts, but applying new rules to any new money coming in from X date onward, is another very large camel that's got his nose under the tent.

MR. JOHN K. BOOTH: At the panel discussion, "Impact of Federal Income Taxes on Product Design," John Adney mentioned that the staff of Capitol Hill is enamored of grandfathering only old money, which was it they treated annuities a few years ago. In its view, it seemed to work then, even though it would work with great difficulty in life insurance contracts.

I'd like to make one minor comment, Harold. I think you said the new special modified endowment provision would be in Section 72. My understanding is that it's back in Section 7702.

Filling in what happened, a letter was sent on Friday, May 13, 1988 to each member of the House Ways and Means Committee signed by Dick Schweiker of the ACLI, Jack Bobo of the NALU and William Regan of the AALU. Basically, the joint proposal was presented as a new proposal of the three trade associations which would deal with the tax questions raised by investment abuses of life insurance. It would do so in a manner that does not jeopardize the current tax treatment of other life insurance policies. There are three principal points in it. You mentioned a new category of contracts identified as modified endowment contracts. These are contracts which are susceptible to investment uses through early distributions and loans. If these contracts otherwise meet the requirements of Section 7702, they would be treated under the Internal Revenue Code

as life insurance contracts, except for purposes of the distributional rules. Special distributional rules would apply to them. The second point is that contracts which are not modified endowment contracts would be treated as life insurance for all purposes, without special exception for the distributional rules. And the third point is that the special distributional rules would apply only to modified endowment contracts issued after the date of enactment of the new law.

The other adjustment in the proposal, which was a compromise among the NALU, the AALU and the ACLI, was that the special distributional rules would apply for ten years after issue. If a contract continued on beyond that, it would basically revert to a normal life insurance status. This is the joint proposal of the industry. We'll probably get a bill that will be somewhere between the industry proposal and the Stark-Gradison Bill because that's how things usually work. You put something on the table and the Congress starts from somewhere else and you end up somewhere in the middle. It's hard to say where that will be at this point.

The other key thing is there may be a lot of work going into this within the next month or so and then the whole process of a technical corrections tax bill may break down without producing a bill at all this year. It still doesn't mean that it's not important because this year and next year and probably the year after that the Congress is going to be looking to the life insurance industry for revenue. We know that there's a budget crunch and people are looking at a lot of things that we're doing. They're saying we really got away without much harm the last time around, so it's time to get us. We'd better be ever vigilant.

MR. JESSE M. SCHWARTZ: A very important point for those companies who write paid-up insurance riders is to pay attention to the grandfathering provisions of these bills. For those of you who are not aware of them, the paid-up insurance riders essentially purchase single premium insurance and pieces of single premium insurance each year. Depending on how grandfathering works, you can have a very, very complicated rule with regard to how the in-force policies are treated as well as how the new policies are treated. For instance, will each piece of coverage purchased have its own five- or ten-year period of time? And then how do you treat these policies when they are surrendered? As proposals are considered over the next month or so, lobbyists in your own company or your representative to the ACLI should really mention exactly what you would like to see done, because that will have a significant impact on these types of riders.

MR. MILLER: Because the situation is so murky, there's an additional dimension in contracts with these riders depending on the extent to which the policy/rider combination puts the whole package over or close to the five-pay limit.

MR. SCHWARTZ: What has been the reaction of companies marketing traditional permanent plans of insurance to the decline in yields obtainable of new investments and, in particular, their dividend distribution policy? Until recently, companies marketing traditional permanent plans of insurance were faced with the luxury of dividend payouts in excess of dividends illustrated at sale. Increases in new money yields, coupled with mortality improvements, overcame the impact of inflation on unit expenses to produce this result. While companies would have preferred that distributors recognize the high dividend payout versus illustrations as a commitment to the mutuality concept, agents began to expect that the dividend payout on more recent issues would continue to outpace illustrative dividends by historical levels.

Further, to compete with nonparticipating, interest-sensitive life insurance plans illustrating premiums paid over a limited duration (assuming the continuation of nonguaranteed, current assumptions), participating plans of insurance began to merchandise similar techniques based on the surrender of dividend additions; i.e., the vanishing premium concept. This vanishing premium concept was particularly attractive when an enhanced dividend payout was offered to in-force policyholders with fixed loan rate provisions, if they switched to either a dividend payout based on direct recognition of policy loans and/or a variable loan interest rate provision.

How have companies reacted to declining yields and the uncertain future of mortality experience because of AIDS? There is great concern with being the first company to lower the dividend scale and the reactions of their distributors and their policyholders.

In order to maintain the highest yields possible, there have been trends towards greater equity investments in the hope that these investments will provide higher yields to maintain the dividend payable scale. However, these investments create difficulties. The volatility associated with common stock investments makes it difficult to manage statutory surplus if an imputed yield is assigned to common stocks for the determination of dividend payout. Real estate offers another investment choice. However, depreciation may cause significant statutory surplus strain, and the recent lack of appreciation in real estate values makes it difficult to place an imputed long-term yield to this investment. The use of equity investments is a justifiable approach to maximize the dividends illustrated and paid if the company can manage statutory surplus strain and realize the assumed imputed yields.

Second, it may be possible for companies to realize gains on the sale of high-yielding fixed income investments made when interest rates peaked and use the gains to maintain the current illustrative and payable scale. However, these gains have a limited lifetime and it becomes questionable how illustrations can assume the maintenance of the scale based on this temporary solution.

Those companies which adopted new money interest rates as the basis of dividend allocation began the process of weaning their distribution outlets from the concept of stability of dividend payout; i.e., the relationship between dividends illustrated and dividends payable. As a result, subsequent reduction in dividends paid to in-force policyholders versus illustrations may have been more easily accepted.

From the perspective of a company continuing to base dividends on a portfolio interest allocation, the initial reduction in dividends below illustrated levels is likely to have a more adverse marketing reaction, particularly if the policyholder is presented with a longer premium paying period than originally illustrated. The problem may be more in the mind of the agent than the policyholder. There are a number of companies which have reduced their illustrative and payable scale in response to declining yields. I would hope you who have experienced reductions in your payable scale will share with us your experience.

MR. JAMES P. VAN ETTEN: At Mutual Benefit Life, we made a rather large cut in our dividend scale effective January 1, 1987. Our management had asked us how far dividends would have to go down if interest rates stayed at current levels for the next two, three or four years. We gave them one answer. We recommended not as drastic a cut and were told to go ahead with the drastic

cut. The only area where we got significant negative response was on the single premium life policies whose dividends were cut within one or two years after issue.

MR. MILLER: Are you on a portfolio or new money basis?

MR. VAN ETTEN: We're on a new money basis. The particular block of single premium life business that was affected had not been segregated from the annual premium business sold during the same time period. We do currently have separate investment segments for these different products.

MR. JOHN W. KELLER: At Northwestern Mutual, we've cut our scale twice in the last two years. The first was a very modest cut. We tried to smooth things over by pegging first year dividends so that the first dividend would not be less than was illustrated at the time of sale. The second time, this year, we cut much more substantially and stopped the pegging practice so that it was a pure cut. We geared up for a lot of complaints and started writing pattern letters to take care of the deluge which never came. The policyowners were virtually silent. Several agents, of course, questioned specifics, but I think we prepared the field sufficiently so that they expected it when it came and the reaction was very mild.

MR. MILLER: How have sales been this year?

MR. KELLER: Sales have been just great.

MR. INGRAHAM: John, do you have any situations where your second dividend cut was such that the second year dividend was less than the pegged first year dividend? Or did you avoid that?

MR. KELLER: There probably were some cases like that. The first cut was so minor that we figured about 98% of our policyowners would see their dividends actually go up even though the scale had been cut. But the second year's cut results in almost 15% of our policyowners seeing dividends going down from one year to the next. And even with that happening, we're not getting any sizable amount of complaints.

We are on a portfolio basis. We do try to recognize capital gains in setting our dividend interest rate, but it is not always easy. You can set a realistic portfolio rate based on harvesting capital gains but then to get your investment department to harvest those gains to actually produce them is something else. Also, because the gains flow into surplus and, in effect, into the net gain from operations, you might end up with a negative gain from operations even though you harvested a lot of capital gains.

MR. MILLER: We're in a similar position at the Pru, in terms of what we'd like to do and some of the practical difficulties of carrying it out. One of the things that has pleased me in my short career with Prudential is a very noticeable coming together of the product and pricing people and the investment people. And this is one of the things that's brought us together. They've increased their understanding of our needs; we've increased our understanding of the practical difficulties and reality of the marketplace. At times, we're going to be asking them to do things that they will say aren't exactly right from a timing and investment strategy standpoint. And then our federal income tax experts offer comments on when certain actions should or should not be taken.

MR. KELLER: We've experienced the same thing -- a lot more talking going on between the different departments.

MR. MILLER: Over the last couple of years a number of major mutuals who were on a portfolio rate basis have reduced the interest rates underlying their dividend scale. I look at that as a set of very responsible actions and I think in the end those are the types of actions that are going to strengthen those companies and their credibility with their agents and their customers.

Let me ask a question on another type of product -- indeterminate premium permanent insurance, say indeterminate premium whole life. Does anybody know of a situation where a company with such a product has raised the premium because its previous anticipated interest rate assumptions weren't being borne out? (One.)

I think many of us know of Tillinghast's monthly survey of crediting rates on universal life (UL) and similar products and their interesting side studies. A number of us would be interested in a study comparing the speed of reaction in lowering credited interest rates on UL policies versus lowering dividend scales, especially by mutual companies with originally high portfolio rates.

MR. SCHWARTZ: Is there anybody who has harvested gains on older, high-yielding bonds and used them as a dividend stabilization fund?

MR. MILLER: There was a lot of capital gain harvesting in general that was driven by the 1986 change in the tax law. So, maybe some of those actions got buried in company reactions to the tax situation.

MR. INGRAHAM: One way that's been reflected, Walt, is that it's retarded what otherwise would have been a steeper drop in the credited interest rate. Companies have been able to maintain a little longer or cut a little less the scale from what otherwise would have been the case.

MR. MILLER: Our next topic is one that is pretty much on the cutting edge and has produced a great deal of interest and perhaps some considerable potential. This is the whole topic of development of coverages that will provide for the cost of long-term care. Some of these developments have been using life insurance policies for different purposes by setting up situations where death benefits or portions thereof can be payable on an accelerated basis under certain contingencies.

MR. INGRAHAM: In our product development practice, we're seeing an amazing surge of client interest in this product. I think it's truly the hot-button product of this year. A number of companies have introduced riders paying socalled "living death benefits" for long-term care. For example, ITT Life has started offering a long-term care rider with its UL policies, which pays up to 48% of the death benefit to help cover a policyholder's nursing home costs. First Penn Pacific's new UL policy, which I understand is called Assured Care, will pay a monthly convalescent care benefit up to a maximum of $3,000 per month after a six-month waiting period. And Jackson National's new interest-sensitive whole-life policy called *Lifetime Ultimate* will pay 25% of the death benefit if the insured suffers a catastrophic illness. Now, there are some minor variations among these product designs, but basically they operate as follows: First, the long-term care benefit is attached to a permanent contract as a rider. Second, when the insured is confined in a long-term care facility, the monthly

benefit equal to, say, 2% of the death benefit is paid. There are provisions requiring a minimum number of years in force before benefits are payable, a continuous confinement waiting period and a hierarchy of confinement facilities. By that, I mean skilled nursing, intermediate care and so forth. Benefits can be paid for skilled and intermediate care without prior hospital confinement. The third point is that otherwise payable death benefits are reduced dollar for dollar by cumulative long-term care benefits paid. Surrender values are also reduced. You can either do that proportionately or dollar for dollar. The fourth point is that there are modest charges made from the fund to support this benefit. There's a separate gross premium associated with the long-term care rider to offset the fund charges. For example, ITT's rider on its $50,000 UL policy on a 55-year-old would have a $105 commissionable premium. And finally, if an insured is receiving benefits under this rider, there is also a premium waiver feature that insures that the life insurance policy won't lapse. The long-term care rider has been targeted to insureds aged 25 to 60 who want to provide for their own long-term care needs. Total policy benefits provided are not increased and that's a key point. But rather, they're paid under an additional contingency -- confinement in a long-term care facility. That's why the cost of the rider is relatively low, ranging from 5% to 10% of the life insurance cost. When developing this type of rider, there are a few regulatory and tax issues that have to be addressed such as state insurance department approvals or the definition of life insurance within Section 7702 or taxation of benefits.

Taking the first point, long-term care riders attached to life insurance contracts are new and innovative. Most state insurance departments seem to be enamored with the concept and are working diligently to find a way to approve these products. Several states have found legislators to sponsor enabling legislation. Others have advised companies of the changes necessary to secure approval. However, some state departments can't seem to find approval authority within existing statutory regulations. This may be due to a regulation barring a combination of life and health insurance in a single contract. Or, it might be deemed to not comply with an individual state's variation of the NAIC Model Long-Term Care regulation. But it's encouraging to note that little by little the number of state approvals is growing.

Long-term care riders don't fall within the five qualified benefits under Section 7702. Guideline premiums aren't increased when this type of rider is attached. However, life insurance treatment of the underlying base policy apparently is not jeopardized. As a general rule, benefits received from personal health insurance are entirely exempt from income taxes. There is some question whether longterm care coverage qualifies as health insurance. The question arises because the legislation defining health insurance was written prior to the development of significant amounts of long-term care insurance. But I understand there's Congressional intent to qualify long-term care as health insurance.

Long-term care riders to life insurance really are new and innovative. They provide real insurance value at what appears to be an affordable cost and these riders will allow life insurance companies to compete in the permanent insurance marketplace on a basis other than purely cost. One side feature of this rider is that it may protect that contract from lapse because contract charges are waived while the insured is confined.

MR. JOHN O. MONTGOMERY: In the California Insurance Department, we have problems with these riders because they may violate the standard nonforfeiture law by using cash values for a purpose other than cash surrender. Now, this

is a matter to be argued out and I think our actuarial task force of the NAIC will consider this. But it does appear that some changes in the standard valuation and nonforfeiture laws would have to be made to accommodate them. At the present, the only long-term care riders in California are those that provide some funding to go with the long-term care benefit, which makes them considerably more expensive.

MR. INGRAHAM: Happily, the moderator of this panel is heading a task force looking at the standard nonforfeiture law.

MR. MILLER: That's another interesting item for our committee. So, even though we seem to be paying the death benefit in a new type of situation, you're saying there's a view that it really constitutes a use of the cash value in a way not contemplated by present legislation.

MR. MONTGOMERY: That's right.

MR. MILLER: Why wouldn't you say, John, that all that's happening is that the company is losing some interest on the death benefit because it's paying all or a portion thereof before it would normally be payable? I'm baffled as to how the cash value is a factor.

MR. MONTGOMERY: I would like to see this benefit go through but until we resolve the legal questions, we are going to have a problem. I think it can be resolved, but it may take a little time.

MR. BRUCE E. BOOKER: Harold, the accelerated death benefit sounds like it usually reduces the ultimate death benefit. Wouldn't that reduce guideline premiums once you start taking money out of the policy every month or every year?

MR. INGRAHAM: I'll have to look into it more. I was told that the guideline premiums were not going to be reduced when the rider was attached, even though you were anticipating the death benefits.

MR. BOOKER: Not when it's attached but when you pay out something. At that point, you're reducing the death benefit dollar for dollar.

MR. SCHWARTZ: Are waived premium payments made on the base policy while benefits are being paid out of the long-term health care rider?

MR. INGRAHAM: No, the basic policy keeps chugging along just as though you had a standard waiver feature on an ordinary UL policy.

MR. MILLER: That's a design feature that someone developing one of these coverages could consider. It obviously makes the thing more attractive if you're able to say that premiums can be waived while the benefits are paid.

MR. MONTGOMERY: Walt, the Tweedie committee, a new NAIC committee advising the actuarial task force on revisions to the standard valuation law, is already working on the valuation of long-term care coverages.

MR. MILLER: It's good to hear that there's enough interest in the regulatory/industry community so that this issue hopefully won't drag on for a long time.

MR. INGRAHAM: Considering the interest in this product, John, I'm very pleased and heartened to hear that this is being addressed so early by your task force.

MR. MONTGOMERY: I would also raise the issue of financial reporting. We'll have to split out the long-term care benefits, but I'm still struggling with the Blanks Task Force. We may start with some notes to the financial statement. But somehow, we've got to get statistics on long term care insurance and bring it into the Blanks so we can start surveillance tests on them.

MR. MILLER: I would like to point out that there are two branches that are appearing out of the basic tree. The one that we focused on during most of the discussion is a periodic payout of some of the death benefit for a long-term care need. The other way these benefits are developing is a lump sum payment of all or part of the death benefit to take care of an acute medical situation. A simple example of that is a transplant operation and so you see developments on both fronts.

MR. INGRAHAM: One of the points I should make, Walt, is that there's also emerging interest in attaching this rider to existing contracts.

MR. MILLER: Our agents are showing a great deal of interest in this benefit for new contracts. They feel most of the in-force contracts are too small to provide any sort of meaningful benefit applied in this way. So they would rather have something that can be attached to new policies to hopefully enhance the size of those policies to be sold to people in the target age group. It was an interesting reaction.

MR. SCHWARTZ: GULPs have characteristics of both individual and group insurance. How has GULP been marketed? What is likely to be its impact in the individual line of business? In some companies, GULP is marketed by the group department; in others, by the individual department; and by both departments in some companies, leading to the peculiar situation of two quotes to the same bid specifications by the same company.

The GULP marketplace was initially developed by the group insurance line and involved the marketing of a death benefit equal to face amount plus cash value. The benefit managers, with whom the distribution outlets of the group insurance department dealt, were comfortable with a benefit which provided, in essence, a yearly renewable term configuration with optional deposits into a side fund. This was very similar to their current experience with group insurance and pensions. This selling technique has been somewhat of a surprise since one of the key selling points of GULP is the ability to prefund postretirement life insurance coverage. The jury is still out whether these contracts will be sufficiently funded to provide for the postretirement death benefits employees expect. Individual departments have been successfully marketing subsets of GULP under the label of individual payroll deduction for years.

The flexibility and customization provided by a group contract form versus the limited flexibility inherent in an individual form is of critical importance in this marketplace, since competitive advantage will be gained by those companies that can meet the needs of the individual cases. It will be necessary to negotiate commissions based on enrollment needs of the case and the competitive environment, and the underwriting applicable to the case. This will result in variations in front and back-end loadings and cost of insurance rates at the case level.

It is likely that the expertise of the individual line of business with respect to UL product design and the marketing of the permanent insurance concept will need to be combined with the knowledge of the group underwriter and group sales force to successfully market this product. Plus, a critical issue will be the ability to find an administrator capable of servicing permanent insurance in large numbers. The companies which successfully combine these attributes will be most successful in distributing this product.

MR. MILLER: That is a very important statement. In the payroll deduction market, if you don't have a good administration system or if you don't have access to one via a working agreement with an outfit whom you know and trust (because after all it's your paper that they're processing), then you're missing a very important point.

MR. SCHWARTZ: The GULP marketplace is extremely diverse. Professional law firms want to use GULP for insurance plus the tax deferral in the life insurance policy. Jumbo-sized cases, like large universities, want to cover all of their employees, the teachers and the staff. The marketplace is so diverse that there are probably enough sales for any companies interested in pursuing them. But you have to enter with a commitment, have experts in this marketplace to market to it, and identify your niches. You just can't go across the board. But where people typically would think of GULP as a group product for group disciplines, I would say that the company that successfully combines the expertise of the group department with that of the individual will be the company that's most successful in getting into this marketplace and penetrating it most successfully.

MR. INGRAHAM: Jesse, are you seeing much evidence of negotiated commissions in the larger cases?

MR. SCHWARTZ: Commissions are specified by consultants or by the insurance company and its brokers or agents depending on case needs. For example, enrollments may be one-on-one or on a group basis by the broker or the benefit manager. A company may make some direct payments to the broker. These kinds of issues will determine what commissions are going to be paid.

MR. MONTGOMERY: How are you planning to do your reserves and non-forfeiture values? Are you going to follow the NAIC Model regulations?

MR. SCHWARTZ: I would think that those companies who are selling GULP and permanent insurance will follow the NAIC.

MR. MONTGOMERY: I see, because we're planning on changing them for all universal life. We're having a lot of problems.

MR. BOOKER: We've looked at a lot of systems to do these things and we can't find any. So we decided to do it ourselves on some PCs and hope that works. We have been selling employee payroll deduction plans for a long time, but not as successfully as a lot of people have. But we've been trying hard and like everybody else we're interested in the GULP because there's a lot of money there but we're not sure how to get it.

MR. MILLER: Three or four years ago, there was a great deal of talk about what some firms dubbed "selling in the marketplace." A lot of people were saying that we're making a mistake thinking of payroll deduction as an offshoot of our agency or brokerage system. This is a whole new distribution system,

the absolute wave of the future. Is anyone associated with a company that's been active in this market with this system that would like to tell us something about how they see things, how they've been doing?

MR. INGRAHAM: My former company, New England Mutual, has been extremely successful penetrating the 401(k) market, using UL and also a traditional contract with various other funds, particularly mutual funds. And their sales success has been remarkable. They told me that 55% of those who opted into 401(k) plans (these are typically the plans in the 30-500-life sector) buy life insurance, which is rather remarkable. Clearly, the persuasive argument to the customer seems to be it's a way, without much medical underwriting -- either simplified issue or, in some cases, outright guaranteed issue -- of getting insurance using before tax dollars. It's surprising that so few other companies are marketing in this particular sector, because it seems that in this one particular case they're getting an awful lot of business without much effort. Has anybody else been selling insurance in the 401(k) sector?

MR. JEFFREY C. HARPER: A lot of the companies that already have systems and the right sales people to get payroll deduction products into companies have found GULP good for a couple of reasons. One of them, no offense to Mr. Montgomery, is that it's much easier to get approved. Second, there's a lot more flexibility to customize products for blue collars and white collars. You must already have a payroll deduction system and people around to sell and support GULP. Sophisticated employers will not tolerate poor service.

MR. MILLER: Is the key that you must have a system that locks into whatever payroll system the client uses?

MR. HARPER: For a payroll deduction marketer, that is the case. One of the keys is taking weekly, biweekly, or whatever the payroll scheme is and getting it into a monthly-type premium. So, universal life fits in well for that. GULP fits in even better because you can just accept the money at the insurance company whenever you get it. So, if you have some way to collect the monies from the employer and get it to the insurance company, most of the problems are solved either with payroll deduction or GULP.

MR. MILLER: Let me ask a general question on GULP. All of us are familiar with the rather intense competitive scramble that has developed with individual UL products. Does the same intense competitive picture apply to GULP as well?

MR. SCHWARTZ: I would tackle it in two parts. Companies are selling GULP to in-force group clients to protect their customer base and to new clients. While we have seen some pockets where people are doing some strange things in the large case market, the initial aggressiveness in rate setting seems to have died down when some companies lost some money on these cases. At the beginning of GULP, some rates were deeply discounted but I don't think they are as deeply discounted anymore.

MR. HARPER: We've talked about two basic GULP markets. The payroll deduction market, which may consist of 50 to 100 lives, can be profitable. If you can make profits in payroll deduction, you can make them in GULP. When we merged at TPF&C a couple of years ago, I discovered I might have three clients that would each have to make a quote on the same case for 5,000 or so lives. In that size case a couple of years ago, it was definitely cutthroat. Any positive profits were acceptable to many companies.

MR. MONTGOMERY: Now that we know that there's such a thing as GULP, I'm sure the regulators will be more aware of those contracts. I don't think most regulators even know there's such an animal and I think that's why it's been easy to get these through. They've just gone through as group insurance.

The other thing I wanted to say is the administrative expenses of UL plans are a real problem for a lot of companies. They haven't recognized it in their development and it's beginning to show up in the results on IRAs and a few other areas. Some of these companies do have large expenses which invalidate any other earnings they're making.

MR. SCHWARTZ: I would just comment on that from the perspective of companies getting into GULP or any payroll deduction marketplace. Systems are such a critical part of this that you have to decide whether you want to set up your own system with those developmental costs or whether you'd be better off at least temporarily going out and either buying a package or looking at a third-party administrator to do it while you cut your teeth on the GULP marketplace. At least with the third-party administrator, you negotiate a fee for a certain period of time and you're typically not paying for an enormous start-up cost. So, for those of you who are looking at that, that's probably one aspect that should be considered.

MR. MILLER: Better to cut your teeth than cut your throat. Jesse was talking about strange things going on in the large case market and that's a perfect key phrase to lead into Harold's telling us a bit about leveraged COLI.

MR. INGRAHAM: Let me start by defining some ground rules which seem to apply to most COLI programs. A corporation purchases some form of permanent insurance coverage on a group, typically a very large group, of employees with the corporation named as beneficiary. The coverage may be either individual or group-type coverage. Policies require extremely high premiums. As an example, for one company's product at age 50, the premiums are $133 per thousand. They generate dividends which actually may exceed those very high premiums after a short period of time; less than five years in two cases I know. As covered employees die, the insurance proceeds are paid to the corporation with the intent of using them typically to prefund postretirement health care benefits. The corporation systematically borrows against the policy cash values pursuant to the so-called four out of seven rule under Section 264. Under current tax laws, the loan interest paid on up to $50,000 of borrowed funds per participant is tax deductible while the interest credited to the policy cash value is not taxable. The tax benefits on loan interest and the death benefit proceeds are usually enough to illustrate year-by-year positive after-tax net cash flow to the corporation.

There are an emerging number of concerns with respect to leveraged COLI which, in my opinion, are likely to seriously diminish or even extinguish the attractiveness of this approach to fund postretirement welfare liabilities within the next year. Let's start with insurable interest. In order to reap the tax benefits associated with leveraged COLI, the underlying insurance policies must qualify as life insurance contracts under applicable state law. A valid insurance policy requires that the corporation have an insurable interest in the life of its insured employee. An increasing number of leveraged COLI programs involve thousands of relatively small policies on many relatively low level employees. The strategy here obviously is to maximize tax-deductible loan interest keeping in mind the $50,000 loan cap per participant. But it becomes harder to assert

that these lower level employees have such a relationship within the corporation that a substantial or pecuniary loss will result from the employee's death. Another point is high premiums per thousand. To what extent might a substantial portion of these inflated premiums be deemed single premiums generating cash values with nondeductible loan interest?

Then we get to a recent ruling of the Financial Accounting Standards Board -- FAS 96, Accounting for Income Taxes. FAS 96 makes extensive changes in how firms will account for deferred taxes and deductions. It has employee benefit implications for deferred compensation, COLI and pension plan accounting. I'm going to focus on the implications with respect to COLI today. Relative to COLI, if COLI cash values exceed premiums paid (and they usually do within just a couple of years under the designs that are being marketed), the difference is then deemed a temporary difference and taxes will have to be booked. Under prior rules, many companies have taken the position that since no taxes would be due if the policy were to be held until death, the difference was not a timing difference under APB 11. FAS 96 serves to reduce the book income on the corporate profit and loss statement from COLI, thus diminishing its attractiveness as a funding vehicle. In this regard, it's also worth noting that for 1988 with tax rates at only 34%, corporations with substantial amounts of prior tax reserves will find that FAS 96 reduces the required reserves and they'll be able to book the reduction as income from the change in accounting principles. So, interestingly, this will actually encourage many corporations to adopt FAS 96 early which I think further diminishes the attractiveness of COLI.

In 1989, watch out for further changes in the taxation of COLI policies. One change might be to disallow any tax-free loans on policies owned by nonnatural persons. Congress and Treasury increasingly regard COLI as an end to run-around discrimination rules and Section 415 limits. And it's even possible that they'll start taxing the inside buildup on life insurance owned by a nonnatural person, in other words a corporation. That may be an overly pessimistic scenario, but I think 1989 is going to be a tough tax year all around and COLI is earmarked.

MR. SCHWARTZ: Harold, what's been happening in COLI designs when the policy reaches the $50,000 limit?

MR. INGRAHAM: Under some designs, the loan is capped at $50,000 and the dividends increasingly purchase paid-up additions. This can be true whether it's a so-called traditional contract or an interest-sensitive contract that happens to be participating. In other cases, it's being marketed as a paid-up contract once you get to the $50,000 level, which may take place somewhere between the seventh and tenth durations at some of the ages and designs I've looked at. That produces a less attractive cash flow but I think it also produces a lot less complication as far as administration is concerned.

MR. BOOKER: Harold, companies subject to alternative minimum taxes may not want COLIs because the cash value buildup would then be taxable. I'm not sure whether death benefits would then be taxable under the alternative minimum tax, but I guess that's possible.

MR. MILLER: One last item has been of some interest in the Prudential, which has dominated the variable universal life (VUL) market so far. I think it's fair to say that our VUL product has been certainly one of the most successful product introductions in the history of the business. Our Chairman, Bob

Winters, made a great press conference comment when our 1987 annual statement results were released. He said, "Well, October 19, what did that mean to the Pru? Bad news and good news. The bad news is that we lost $1 billion on paper. The good news is that we had it to lose." I think our experience was typical of that of many companies, perhaps with a few zeroes added on. In financial terms, it didn't turn out to be a terrible disaster but rather the giving up of a lot of gains that had been piling up at a somewhat abnormal rate in the earlier part of the year. The interesting question is what happened out in the marketplace? Are we still selling our VUL product at prior levels and, if we're not, why not? A couple of quick facets of our experience. Bad news/good news. The bad news is that sales are off significantly. The good news is that they don't seem to have been lost sales because the great majority of them are being made instead in our traditional portfolio. The other piece of our own good news is our persistency experience in the wake of the crash. We were nervous about what would happen when the customers got their next annual report. After October 19, there has been no sign of any significant increase in lapse rates or indications they wanted a different product in our own or another company. The results obviously aren't all in, but on balance we're encouraged. Are any of you associated with companies that had been selling one sort of variable product or another in quantity? What happened to you after October 19?

MR. ALAN F. HINKLE: At Provident Mutual, the product that we had been selling was introduced in the fall of 1986. It is somewhat similar to the Pru's in that it's a hybrid product and made up about 30% of our sales in 1987. And our experience was similar to what you indicated. Our sales are down, probably not significantly down, but they seem to have been replaced by traditional product sales. So, in total, we're doing rather well this year.

MR. MILLER: What do you think is responsible for the falloff in variable product sales? In our company, there are two basic theories. One is that it's all in the agent's head and the other is that it's all in the customer's head. Where would you come down on that one?

MR. HINKLE: We're not really sure. We found that a lot is probably in the agent's head because it seems sales aren't evenly distributed across our agencies. Some agencies sell variable products almost exclusively and others won't touch them. So I think agents' attitudes, rather than customers' attitudes, are more responsible for the drop. And I think the agents are the ones more likely to be fearful of the feedback from this falling market.

MR. DAN R. SPAFFORD: In the Equitable, we've seen the sales continue. While our VUL sales have been down a little bit this year, we expect them to increase as the year goes on to about the planned level. We're finding the premium is not going into the variable accounts to the extent it was precrash; it's going into the fixed account. We haven't seen transfers out of the variable accounts with respect to money that was there prior to the crash and we also haven't experienced significant lapsation or anything of that nature.

I'd also like to make a comment. I don't know if you saw the *New York Times* article in the business section on May, 15, 1988. They quoted some figures and prior to the crash, 35% of households were considering making investments in the market and that went down, of course, after the crash. But it continued to go down gradually until very recently. It's at the lowest level it's been in quite

some time -- 3 1/2% of the households. So, it appears that the American consumer is not interested in the market at this time for various reasons.

MR. MILLER: One thing that concerns us at Prudential is that there is very obviously what some people have termed a flight to quality -- pulling out of the market. In particular, our equity-based mutual fund sales have really fallen out of bed. This bothers us, especially when you look at the troubles in banking -- the thrift industry is going to lose $7 billion this year. For reasons unbeknownst to us at this point, we seem to be having trouble getting our share of the flight to quality. In many ways, there are a number of insurance companies that are indeed stronger than an awful lot of banking institutions with big names and yet one of our challenges is how to get that word out in the marketplace and convince customers that if they want a flight to quality, there's quality and safety in the insurance industry in spades also.

MR. SPAFFORD: Except there's no federal guarantee.

MR. INGRAHAM: Another indication of the public's current attitude toward equities relates to a survey I recently did of insurance company experience in the 401(k) market. These are companies selling in the middle-sized market, which I would define as up to 500 lives. Among other things, we found that all the companies had several accounts -- equity accounts, bond accounts, balanced accounts, some real estate accounts and then a fixed income account. On the average, something like 85% of the money is being directed by plan sponsors, often with the input of their participants, to the fixed income account right now.