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MARKETING OF INDIVIDUAL INSURANCE IN BUSINESS MARKETS

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- Markets
  - Deferred compensation
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MR. STEVEN A. EISENBERG: Two of our panelists, Dave Remstad and Rick Kular, will speak from the insurance company's point of view. Our third panelist, John Jarka, will speak from the corporate client's point of view.

MR. RICHARD M. KULAR: Over the last four years I've spent a fair amount of time designing and modifying life insurance plans that are used by corporations to fund nonqualified benefits for key executives. In that time, I've seen a lot of changes that have caused us to change the products that are used in corporate situations.

What I plan to do is give a brief history of how life insurance has been used in business situations in the 1970s and 1980s. I'll talk specifically about key tax changes that have caused us to make changes to the products we sell.

THE 1970S

In the 1970s, life insurance was primarily used in buy/sell agreements and to provide key person life insurance coverage. In short, the focus was on business continuation uses for the most part. These uses have continued to the present. Until 1986, the key financing technique used was minimum deposit.

Some salary continuation plans provided by employers were funded by life insurance, but generally speaking very few corporations were even aware of life insurance as a benefit funding vehicle. Part of the reason, I suppose, is that most ... ions provided to their employees, including their top exec ... der qualified plans.

Exec ... RSA n't popular because of high marginal personal tax rate ... ntrols, introduced in the early seventies resulted in

employers looking at providing benefits in lieu of wage improvements. Split dollar, a concept developed in the sixties under which the employer and the employee split the cost of a life insurance plan was one solution adopted by many employers. Split dollar plans continue to be used today.

In general, plans used to fund business coverage in the seventies tended to be ordinary whole life and term.

LATE 1970S/EARLY 1980S

There were several key developments in the late seventies and early eighties. One of the most significant was escalating interest rates. Dividends paid on life insurance plans continued to improve each year. A neat twist was added to whole life insurance when insurance companies figured out that they could illustrate vanishing premiums. This was a great way for corporations to fully fund a plan of life insurance before an employee retired.

Universal Life plans were developed. These began to be used for business continuation purposes in place of traditional whole life plans as interest rates climbed.

Another key development was the introduction of variable policy loan rates that reflected current interest rates. Variable loan rates, together with policy loan interest deductibility, made life insurance sold on a minimum deposit basis a very powerful asset building tool.

If you are familiar with section 264 of the Tax Code, you'll know that if a policyowner paid four out of the first seven premiums on a fixed premium plan, he was allowed unlimited deductibility of policy loan interest. If he paid us interest at 10%, we might credit his policy with interest at 9.25%. His cost, at a 50% marginal tax rate was only 5%. The 4.25% difference between the credited rate and his cost was a type of arbitrage. These types of differences allowed insurers to illustrate client rates of return significantly higher than the loan rate charged.

At Manufacturers we developed IWL, an increasing whole life plan under which the guaranteed face amount increased each year by 4%. The IWL developed high early cash values which could be borrowed. We were able to illustrate wonderful after tax rates of return to clients. Individuals bought it for personal asset growth. Corporations bought it to fund executive benefits. The IWL was an unqualified sales success.

MAJOR EVENT -- DEFRA

In 1984, DEFRA (Deficit Reduction Act) formalized a definition of life insurance for tax purposes. Endowment plans failed the tests and IWL was no longer considered life insurance because the guaranteed cash values prefunded future death benefit increases.

USES OF LIFE INSURANCE POST DEFRA

After DEFRA, we and other carriers designed increasing death benefit plans that conformed with the new tax law definitions.

More and more corporations were becoming interested in the merits of life insurance as a vehicle for funding employee benefits. Every time Congress talked about further changes which would limit the benefits of life insurance to

corporations interest would quickly peak. Accommodating insurers put a lot of insurance on their books when they offered "fire sales" at such times.

Interest rates were still at high levels in 1985. Competition among carriers led to the development of products that maximized client returns. It was possible to show client rates of return as high as 20% after tax on a mortality adjusted basis or on a death at 80 basis.

In fact, as more companies became interested in the market, creative product designers found ways to push client after tax rates of return as high as 25%.

While par plans had mainly been used in the past, nonpar interest sensitive plans lent themselves more easily to some of the techniques that were used to create the high returns. Actuaries and consultants retained by corporations as advisors favored contracts that laid out guaranteed expense charges, maximum mortality charges, and credited excess interest rates tied to external indices. This encouraged the development and use of nonpar designs.

Charge to earnings became a hot issue. Large, publicly held corporations couldn't accept spending a $10 million annual premium and getting a $4 million first-year cash value. Competition pushed first-year cash values up to 85% or more of first-year premium and caused commissions to be paid out on a more level basis. This was good for insurers because this business needs ongoing service and we would rather pay out significant commission dollars later than sooner.

The uses of life insurance as a funding vehicle increased. It was used for funding deferred compensation plans, supplemental benefit plans, and executive split dollar plans, to name a few.

MAJOR EVENT -- TRA 86

The next major event was the Tax Reform Act of 1986 (TRA 86). Several changes affected COLI products:

Policy loan interest deductibility was wiped out for individuals. Corporate deductibility was limited to the first $50,000 of outstanding loan per individual life insured.

Qualified benefit plan limits were cut quite severely. The 401K annual contribution maximums were dropped from $30,000 to $7,500. The maximum pension at 65 that could be funded was capped at $90,000. And, of course, lower corporate and personal tax rates were introduced.

WHAT WAS THE EFFECT ON NONQUALIFIED PLAN MARKETING?

Two markets emerged as a result of the TRA 86 changes.

First, it was obvious that a corporation could still get some mileage from the interest deduction on the first $50,000 of outstanding loan if the average premium per life was low, say around the $2,000 level. But, the funding of benefits for a key employee typically required much higher premium levels. Annual premium levels of $10,000 and $20,000 were common.

Enter the Financial Accounting Standards Board with FAS87. This statement highlighted the need to recognize the huge corporate liabilities for health benefits for retired lives. It's estimated that these liabilities are at least as big as

corporate pension liabilities. There is still no method to fund these benefits which provides corporations with adequate tax relief if they do choose to fund their total benefit obligations. Life insurance producers and carriers came to the obvious conclusion. They started to investigate the feasibility of using small COLI policies to fund postretirement health benefits on a nonqualified, tax leveraged basis. Unfortunately, funding these types of benefits with life insurance is not as clear cut as funding benefits for key employees.

Insurable interest is a big question. While an employer has an insurable interest in his key employees, insurable interest is generally not thought to exist with respect to ordinary employees. However, some companies are in this market and they must have come up with answers that give them some comfort, though I expect the issue is not 100% clear. A second issue is employee consent. In some states an employer is taking a huge risk insuring an ordinary employee without his or her consent. Another big issue is an insurers' ability to administer thousands of small policies efficiently. Those are the main issues we recognized at The Manufacturers. We aren't pursuing this market, but we were thinking about it.

The second market that has emerged (or more precisely, reemerged, albeit in a revised form) is the one that we were already in: funding benefit liabilities for key executives. With lower qualified plan limits, the market for nonqualified plan benefits has mushroomed in size as corporations look for ways to restore benefits taken away by the tax law. The focus is now on the rates that can be generated on unborrowed cash values inside a life insurance policy. Client rates of return are down to 9 to 11% levels. But, these still look good compared to risk adjusted rates of return clients can generally expect to earn in the market place. Tax free inside buildup and tax free death benefit proceeds are shadowy remains of what we used to have, but they are still enough to allow us to demonstrate that life insurance is a viable funding vehicle for executive benefits.

When the emphasis was on borrowing, nonpar interest sensitive contracts illustrated well. Now that the focus is on unborrowed rates of return, they don't work as well as par contracts. The rates guaranteed under nonpar contracts were generally short term rates. These have plummeted in the last couple of years. Participating plans are of interest once again because of the 11 and 12% dividend scale rates that some companies have been crediting. Interestingly enough, some companies found themselves in this market quite by accident.

Actually, there is one form of nonpar life insurance that might generate high rates of return on unborrowed monies, Variable Universal Life (VUL). It has two main attractions to corporate America. First, the possibility of higher than par rates of returns is there. Second, we're now starting to see the emergence of contracts where the buyer can choose not just the investment, but the fund manager as well. Some of the established VUL carriers have already written huge amounts of coverage for corporate benefit funding purposes. Hundreds of millions of annual premium dollars have already been written in the short period of time VUL has been available. You can imagine the huge market potential that must still exist.

By now, Congress has developed an awareness of corporate interest in life insurance. We can be sure life insurance will continue to be on the list when Congress looks to raising additional revenues in the future. At least forewarned, we stand a chance of continuing to lobby for what we still have left.

CURRENT CONCERNS

I want now to mention some current concerns for those of us in the executive benefits funding market. There are many more issues as I'm sure many of you know. These are, however, some of the things I've been most concerned about and interested in of late.

The first issue is the FASB statement #96. Sweeping accounting changes have been introduced by this document. Life insurance is just one of the areas affected. In general, what has happened is that instead of looking at the profit and loss statements to calculate the additions and subtractions to the reserve for deferred income taxes, a corporation now needs to look at the assets shown on the balance sheet.

Gains over basis have always generated tax at the time a policy is surrendered. But, the tax has never before been recognized before it has been incurred. Despite the fact that life insurance is bought for the death benefit and not for surrender purposes, corporations now must hold an accrued tax liability based on any gain that would be taxable if the policy were to be surrendered. While the industry did lobby to get this changed, there were too many other interest groups affected by this new accounting standard. The Board refused to review our concerns on an exception basis. So, it looks like the new rules will stick.

The life insurance producers in this business have already fallen into step with the new rules. After all, a new client who doesn't know what he's missing doesn't know any better. Actually, the better explanation is that there are ways to structure benefit recovery out of the contract that counteract some of the tax accruals. And, in any case, this is really only a temporary problem. On death, the accruals are reversed. On a mortality adjusted basis results don't have to look very much worse than they did on the old basis. One thing you learn about the mega producers that are in this market is that they are some of the most creative people around, and also some of the most optimistic.

The second big concern that has worried us at The Manufacturers is the approach that will ultimately be used to close down the tax abuse that was possible under single premium life insurance. The March testimony of the General Accounting Office to the Subcommittee of the House Ways and Means Committee investigating Single Premium Life Insurance provided some interesting facts, and I quote, "By the end of 1987, insurance companies collected almost as much revenue from single premium sales as from first-year sales of periodic-pay ordinary life insurance. Between 1984 and 1987, single premium sales grew 850% from $1.0 billion to $9.5 billion. During the same time, the premiums on sales of periodicpay life insurance products grew 20% from $8.3 billion to $10.0 billion."

Is it any wonder Congress wants to close down a publicized tax loophole that seems to have escaped tax reform?

The concern for those of us in the COLI business is to avoid a solution to the single premium "problem" that also impacts on "legitimate" life insurance products and marketing applications. The original Stark bill introduced last fall has implications far beyond the single premium market, but it now appears there is a strong likelihood that an approach which defines tax abusive contracts and imposes penalties on withdrawals out of them has a strong chance of getting adopted.

Two separate industry responses had been proposed. One proposal was a joint effort by the National Association of Life Underwriters (NALU) and the Association for Advanced Life Underwriting (AALU). The other was presented by the ACLI. I just learned that a compromise proposal has been agreed to by these associations. I just hope that the ultimate solution fixes the single premium problem and doesn't close down any more of our markets than it has to.

CONCLUSION

I would like to conclude by underlining the basic theme of my remarks: that the corporate-owned life insurance market place is very dynamic and very susceptible to changes in tax legislation.

It is not a market for the faint of heart; nor those prone to ulcers. It is not a market for the conservative insurance company. I have described to you at least five occasions in the past four years when an event outside my control has appeared to put me out of business. Congress and the Treasury Department continue to keep us in mind. Supposedly, the Treasury Department is reexamining the $50,000 loan interest deductibility ceiling. The Department of Labor is considering making tophat rules more restrictive, and others are looking at further tightening of the definition of life insurance. Changes as a result of any of these investigations could seriously impact the COLI business.

We've absorbed more knockdown punches than Sylvester Stallone did in all four Rocky pictures combined. But, like Rocky, those companies and producers that have the stamina, creativity and determination to bounce back, can reap the immense rewards of satisfaction and profitability.

MR. JOHN JARKA: Primarily, I'm trained as a pension actuary, although I started my actual training with a life insurance company. In 1984, I found myself with AT&T. They were thinking about buying life insurance to fund some of their executive benefits, and they felt they could do it only with adequate consulting assistance. I got the assignment to do the actual broker selection, product selection and carrier negotiations. We consummated a sale and then because of their network I wound up being a consultant for several of the other major telephone companies which had been divested in 1984. I, also, have done similar consulting for corporations like Coca-Cola, Kodak and Tenneco.

As in most businesses, you enjoy a brief period without too much competition and then suddenly someone decides this looks good, and soon most of the major consulting firms come up with their own in-house specialists. I found another market niche which seemed to have been unaddressed; that was the brokerage side of the process. As I'll get into a littler later, the corporate buying process is unique -- you don't sit across a kitchen table and convince the other person, the buyer, that there's gloom and doom ahead of him and he really should sign on the dotted line and he really shouldn't leave the house until he does so. The process is a consulting process and the brokers were finding that without adequate technical assistance on their behalf, they were at an extreme disadvantage. Since October, I have been primarily consulting on behalf of the Clark Bardis organization which has seven large and approximately 20 small brokerage locations in the United States. I am available as a technical assistant to any one of them on the sales process.

When you go into a corporation, (I know it from both sides because I was AT&T's consultant and now I'm the broker's consultant), you have to understand what the corporate motives are in even pursuing life insurance. You have two

groups of people -- the executives and the rank and file. The solution is a lot of policies. The only benefit that I run into that is trying to be solved by the use of life insurance, which is not related to life insurance, is postretirement medical insurance. The connection is that a corporate owned life insurance minimum deposit policy creates income in the form of tax savings and those tax savings can be used to eliminate or to reduce the cost of postretirement health insurance. There is no current way of funding or financing the benefits. When the FASB decides that you are going to put a liability on the books, it's going to stay on the books regardless of whether or not you have corporate owned life insurance in place to create the funds to pay for it.

Almost all the other benefits are executive benefits and the objectives are either the restoration, the improvement, the security, or the creation of new benefits. The tax changes that have taken place in Section 79, Section 401K, and 415 have reduced significantly the corporation's ability to deliver qualified benefits to its executives. However, the executives have not accepted that they have reduced their need for such benefits, so you have a gap that has been deliberately created by the Congress. Congress says you can provide the benefits, but we're just not going to pay for them.

With regard to the restoration of benefits, life insurance is being considered quite frequently to restore group insurance that had existed either in a discriminatory plan or that is created by the action of a nondiscriminatory plan on salary in excess of $200,000. These could possibly be financed with life insurance where the corporation's going to pay the benefits out of corporate funds and then recover those costs, or actually funded where there is a direct connection between the policy and the benefit to be provided.

With regard to the creation of new benefits, many of the corporate plans provide adequately for death preretirement, but they're inadequate with regard to postretirement. One of the newest benefits is a continuation of a high level of insurance after retirement, two or three times salary. The corporate insurance brokers stock in trade has always been the deferred compensation plan. Life insurance, especially arbitrage life insurance, was used to create rates of return on deferred compensation far in excess of those available in the investment marketplace. I have in fact come in contact with plans where the credited rate on deferred compensation is 24%. There are frequently plans where the compensation being deferred at ten years treasury at plus 5%. This has been accomplished with leverage life insurance.

The limitations on leverage life insurance have created a dilemma. Do we in effect pay for the high interest rates with the deaths of the rank and file employees or do we reduce the expectations? Do we go back to a realistic expectation rate? The human resource people are very reluctant to fund these benefits or finance these benefits using anyone other than the people who benefit.

A very interesting area for using life insurance is the benefit security area. We went back, for one of my major clients, to the textbook from 20 years ago on traditional split dollar life insurance. It said, in effect, if you really are concerned about insolvency and if you really are concerned about takeover and you have an executive who has a major benefit promise which has no security to it, you can structure a split dollar arrangement in such a manner as to create that security by creating the potential ownership of the cash value. If you do it in a creative manner and you do it through what little guidance you get in the

internal revenue code and its regulations, you can solve those two problems in a way that cannot be solved with other traditional applications.

With regard to improving existing benefits, we are seeing a lot of variable universal life being used to improve the cost of death benefits. Using the group approach, you can give the executive the option of buying his group insurance through the group, which I think longterm is going to create some real antiselection problems for the remaining group coverage. But, in any event, the variable universal creates a margin account and that margin account is used to subsidize the mortality and to make it a very attractive death benefit delivery system. We, in fact, don't run into very many situations that are not executive oriented -- our people have tended to concentrate their efforts in the executive marketplace.

There's a concept called strategic selling where they talk about a technical buyer -- I consider myself a technical seller. I interface with a technical buyer who in a major corporation has to be comfortable enough to be willing to say if this goes bad, I take a black mark on my career record. It's a major purchase and we're talking about large amounts of premium investment. The corporate buyer tends to not want to make that commitment unless he's comfortable with and understands what he can make from it.

There is a concept that I refer to as brokerage consistency which has nothing to do with the continuation of business on the books. It has to do with how many calls you get from a broker. On a regular basis, the broker is calling the human resource people and any other contact he has in the company. He's mentioning major corporate needs. It is very difficult for a staff person to walk away from that. If he says there's nothing there, then why is XYZ doing it? Why is my friend at the club telling me that he's getting 20% on his money and you're giving me 7% on my money? Therefore, the broker is very instrumental to the corporation, even considering the purchase of life insurance.

Life insurance does have certain tax advantages. When I talk to the buyer, I tell him in no uncertain terms that these are not loopholes. These are conscious provisions to the tax code with respect to life insurance. Whether or not Congress changes it's mind is another issue, but when a provision like Section 264 is revisited in 1986 and when Section 7702 is revisited in 1986 and conscious changes are made to those provisions, this is not a loophole -- this is not something that's been overlooked. There is always consideration as to whether or not the advantages provided in the tax code through life insurance will remain. But nevertheless, they are there as an incentive to the buyer, and if the buyer misses that incentive, the buyer is missing an opportunity that was deliberately created by the Congress.

Tax advantages are, of course, the inside buildup, the delivery of tax through death proceeds, and the interest deduction -- the deductibility of the loan interest. My guess, and we deal very closely with lobbyists, is that very little will get done this year in Washington because of the uncertainty in the political situation to begin with. There's a close presidential race that does not lend itself well to considering tax law changes.

But every one of the programs that we work with takes advantage in one form or another of one or more of the tax advantages. The issue of funding versus financing has led to things like the split dollar life insurance policy coming to the forefront as a major funding vehicle.

The funding of qualified benefits has been severely restricted and benefits for executives at the $90,000 level in some cases provide 10 or 15% of their final pay. They feel that they are entitled to more. They also feel that they are entitled to be relieved of the pressure of wondering whether or not someone will come in, snap their fingers and take these benefits away. The pricing of the insurance has gotten to the point where a corporation's investment analyst can clearly look at these as investments. We typically will look at policies where the commission rates are less than 2% per year over the first ten years and either disappear when the premium disappears or continue with service fees. If you would have told me two or three years ago that someone could stay in business with that kind of compensation, I would have laughed at you, but in fact that's the compensation. The marketplace has forced the insurance companies to very seriously consider whether or not this is the place for them to be and whether or not they can take the risk that they price slightly wrong and put themselves in a potential loss position.

One of the things that I would like to share with you is the corporate prospect. The life insurance sale to major corporations is not one-on-one between the broker and the buyer. The corporations that I get involved with will almost instantaneously turn to their consultants. The consultant, if knowledgeable, will either work directly with you or will create what they call a bid process. Split dollar policies are very difficult to bid because the real differentiation is in the investment rate. Once you have priced out the loads, the question is who is going to deliver a reasonable return on the invested money? We have found that it's a difficult process to be competitive in the split dollar arena. A company with a 12% current dividend scale can't be expected to keep that up. A company with an 8% current crediting rate should be able to keep that up; so you get into discussions on investment performance which really is not a fun area to be involved with.

One of the attractions that the variable universal has is "self directed investment" if we can find a way to define that as life insurance -- it puts the investment performance risk back in the hands of the investment people of the corporation. The pension fund managers would fund it through the qualified plan if they could, and therefore they would get to manage the money and be responsible for the performance of the investment. I think that's a good idea. Many of the carriers are responding to that.

The carriers that have stayed in this marketplace are the carriers that have been found to be flexible and responsive. Once a consultant is involved, the consultant has to distinguish himself or herself as having done a good job. One of the things that distinguishes a great job is negotiation of terms, either through the carrier or through the broker or both. The carriers who are flexible and responsive are going to be the ones that stay in the marketplace. In the last two years, we have seen that universe just diminishing tremendously.

MR. DAVID REMSTAD: To be competitive in the corporate owned life insurance market today requires more than just a policy form that takes advantage of the latest provisions of the ever changing tax code. It requires a commitment to the very special service requirements of the corporate market. Just as it is necessary to have products designed specifically for the corporate market, at Northwestern Mutual we have discovered that it is increasingly important to have service systems designed specifically for the corporate market. These special systems devour home office resources, both computer and staff. The service requirements of the corporate market have also led us to reconsider our field

compensation. I would like to share with you some of my observations on this, the less glamorous side of the corporate owned life insurance market, policy service and administration. I will comment briefly on illustrations, premium billing, policy changes, reillustrations, underwriting and field compensation. Please note that my perspective is as an actuary for a mutual company with a captive field force and whose market is relatively small cases. Some of my comments may not be applicable to the corporate market as a whole.

I would first like to comment on illustrations. We decided to have a separate illustration system for the corporate market, rather than try to expand our personal market system. This is because as policy design has become more complex, sales illustrations have been forced to become more sophisticated. For example, Northwestern Mutual's product designed exclusively for use in the corporate market is called corporate Complife. It consists of three components: annual premium whole life, single premium whole life, and yearly renewable term.

A corporate Complife can only be constructed and issued by using a complex computer driven illustration system. Currently, the product is installed only on a time-sharing basis on the illustration system of an outside vendor, Compensation Resources, Incorporated (CRI). Based on dozens of input commands, the illustration system uses iterative logic to solve for the mix of the three components, that for a level annual premium, will provide exactly the death benefits and cash values to fund the varying annual needs of the plan. Unneeded benefits are eliminated and the premium is reduced. The result is that we have a very competitive product, but at a cost. The illustrations are very expensive because of all the central processing unit (CPU) time used by the iterative program. Each time any of the input assumptions change, another expensive illustration must be run. Since we are using a vendor's product, we can't make the illustration system user friendly. Therefore, we have to allocate home office staff to help agents produce illustrations. Because of these problems, we have decided to develop our own in-house illustration system. Due to programming support constraints, the in-house system will be limited in its flexibility. We will still use the CRI system for the complex cases. It will be an expensive and time-consuming proposition to maintain dual illustration systems.

We feel we may have reached the ultimate in product complexity. If we go any further, our products may no longer be fully understood by either the corporations, or more importantly, by the agents and home office staff who must service them.

One interesting thing we have done to reduce complexity is that each time a corporate Complife illustration is run, all vital policy parameters are passed directly from the illustration system in the field to the home office by an electronic record. Each electronic record is identified by a unique code number. This unique code number also appears on an "application supplement" page printed at the end of each illustration. After the corporation decides which of several alternative illustrated policies it would actually like issued, the application supplement is signed, attached to the application, and sent to the home office. Then, using the unique code number, we access the appropriate policy information needed for underwriting and to set up our policy administration computer records. This electronic record greatly reduces the possibility of clerical error during application input.

We have assumed in the past that the corporate market was dominated by sophisticated agents selling to sophisticated corporations. But as other agents

discover how lucrative the market can be, and smaller corporations discover the benefits of funding nonqualified employee plans through insurance, we will have to rethink that assumption and explore the consequences.

One concern I have is that these sophisticated illustration systems might be misused by the unsophisticated agent. For example, regulations could change to allow corporate policies to be illustrated at higher than current scale but still require personal policies to be run at current scale, or lower. If personal policy forms are also being used in the corporate market, the problem could arise of agents running personal illustrations on the corporate system using illegal higher than current dividend scale rates. Other problems could arise because of the flexibility allowed by current corporate illustration systems. For example, the CRI system we use allows any combination of output columns to be illustrated. But most states have solicitation laws which require that if nonguaranteed values are shown, guaranteed values must also be shown in "close proximity." An agent could neglect to include the guaranteed columns and produce an illegal illustration. The CRI system we use also allows the agent to choose column headings on the illustration. A mislabeled column could cause misunderstandings or even legal problems for which the insurer is ultimately responsible.

Another question with illustrations is do the relatively unsophisticated corporations understand the nature of illustrations, namely that they aren't projections? This is very important to us since the premium determined for our corporate Complife policy is highly dependent on the interest assumptions made, particularly the dividend interest rate assumption. Do corporations understand the effect on premiums of the loss of loan interest deductibility? Do they understand the effect on the number of years required to vanish the premium if the dividend scale drops? In this era of declining interest rates and increasing mortality, we have decided it is a good idea to reemphasize to our agents the nonguaranteed nature of illustrations. But, in case that doesn't work, for the first time we have created a home office position whose sole function is to handle complaints about agents' sales practices in both the personal and corporate markets. We expect complaints to increase as experience does not always match illustration.

Like illustrations, postsale service is more complex, more time-consuming and more important in the corporate market than it is in the personal market. This is true for both the agent and the home office.

The first important area of service is the handling of premiums. Corporations like to pay as few premiums as possible in cash. Instead, as soon as possible, the premiums are paid by borrowing, surrender of cash value, or dividends. It is the agent's responsibility to arrange the premium payment scheme. In the past, this meant that in order to meet the definition of life insurance, the agent had to check that four out of the first seven premiums were paid in cash. The agent would also have to notify the home office which premiums were to be borrowed. With the loss of interest deductibility on loans over $50,000, the favored method of premium payment has shifted from loans to surrender of cash value. This is easier on the agent, but he must still arrange the surrenders with the home office and check that distributions do not exceed basis.

Corporations also do not like to receive a premium notice for each individual policy. Therefore, we prepare a single premium bill for the entire case. This is an example of where we have found it is advantageous to apply group insurance

practices to individual policies. Although group billing is more convenient for the corporation, it is a mess for the home office. Currently none of the individual policies in a case are tied together on our computer records. We have 37 people in the home office whose only job is to manually prepare group bills for both the nonqualified corporate and the qualified pension markets by summing the individual policies' premiums.

Another service problem in the corporate market is policy changes. As we have developed unique products for the corporate market, we've also been forced to develop unique policy change procedures. Some of the policy changes are so complex and nonstandardized that we have not automated the home office work. The worst policy change, for both the home office and the agent, is a change of insured. I'm sure this is true for most companies in the corporate market. If an employee leaves a plan, the corporation will usually move the coverage to a different plan participant to retain any grandfathered tax advantages and to avoid having to repay acquisition expenses.

We have found that among the types of employees covered by nonqualified plans, turnover is quite high. Therefore we do a surprisingly large number of change of insureds. A change of insured is made even more complex when a senior employee with a large amount of insurance leaves the plan and the coverage must be split between two or more junior employees.

Another service responsibility of the agent is education. The agent is often called upon to educate the corporation's employees about the plan provisions. This process can be quite extensive, especially for deferred compensation cases where the agent must basically sell each employee in the plan individually. It is also crucial that the agent takes the time to educate whenever the corporation's benefits coordinator changes. It is too easy to lose a case if the new coordinator does not understand the plan or feels the agent is not giving adequate service.

A final area of postsale service required of the agent is the tracking of benefits. Since experience will never exactly match assumptions, it is also the agent's responsibility to compare the insurance actually in force to the corporation's current needs. The frequency of this checking is a function of how conscientious and well-compensated the agent is. This checking also requires an InForce Ledger System equal in sophistication to the Sales Illustration System. Although shortfalls in coverage present the agent with a sales opportunity, it is time-consuming work to determine the amount of new coverage needed. Complexities are introduced because of unexpected salary increases, new employees, terminations, partial vesting, early retirement, and integration with tax-qualified plans, especially with allowable contribution and benefit limits constantly changing. We have found it necessary to have several well trained home office employees spend part of their time on helping agents in this aspect of corporate policy service.

To date our agents have been faithfully servicing our corporate policies. With the increasing complexity of product design, will they be willing, or even able, to do so in the future? What happens when the agent retires or dies? We have to realize that the ultimate responsibility for service lies with the insurer.

I would like to comment briefly on a very current underwriting topic, AIDS testing. Individual insurance in the corporate market is generally underwritten on some type of nonmedical basis. The amount of individual underwriting

decreases as the size of the group increases. Large enough groups may be underwritten on a guaranteed issue basis. If you haven't done so already, you might want to investigate AIDS testing for your corporate underwriting programs. At Northwestern Mutual we have decided to tighten our underwriting of AIDS. We are asking both an AIDS question and doing blood testing. Where legal, applicants positively responding to a question about medical diagnosis, advice, or treatment for AIDS or ARC will be declined. Also where legal, we will perform HIV blood test on applicants for insurance amounts over defined limits. The limits increase as the number of lives in the group increases and are currently above our testing limits for the personal market. We are considering lowering the limits to bring them more into line with our personal market limits.

We have seen that in many ways the service requirements of the corporate market are different from those of the personal market. This implies that traditional individual life insurance commissions, in other words a very large first-year commission, followed by much smaller, decreasing renewal commissions, may not be appropriate for the corporate market. Do individual type commissions adequately compensate agents for group type work? Another problem is that the insurance used to fund a plan can be a mix of whole life, term and single premium life, each with a different commission. The agent is faced with a conflict of interest. The mix that produces the highest commissions for the agent is not the best mix for funding the corporation's plan. Yet another problem is that insurance company contracts with agents generally don't require the writing agent to service a case. If the writing agent drops a case, how will another agent be compensated for his service work?

These problems have led to a shift in the corporate market away from individual type commissions to group type commissions. Here are some of the alternatives being used today. Some or all of the renewal commissions could be replaced with service fees. This would encourage another agent to service the case if the writing agent drops it. Commissions could be set at a low, level percentage. This would emphasize the importance of consistent long term service. Some companies are setting commissions to zero or allowing the agent to choose the commission level. This assumes the agent will negotiate a fee for service with the corporation. Corporations are very aware of the cost of field compensation and agents have been forced to take lower commissions and fees to sell cases. This leads to a question. Do agents really know what their expenses are and do they have enough power with the corporation to negotiate an adequate fee?

In summary, every tax law change seems to further restrict qualified benefits. This increases the market for corporate owned life insurance, which traditionally has been used to fund nonqualified benefits. Although the corporate market presents a great sales opportunity, it is vital to understand the very real and very long-term commitment to service and administration required of both the agent and the home office.

MR. EISENBERG: My comments are more or less in the nature of questions. Under FAS 96, where a corporation has to set up a deferred surrender liability, I believe it will be much easier for corporations to surrender their policies since there will not be an additional charge to statement. Much of the profit testing has assumed no lapses and basically looked at the surplus levels from period to period. If a corporation really is setting up a FAS 96 liability, then it can more readily surrender, although it may be a cash flow consideration and not have

any impact on its earning statement. We may therefore see an increase in surrenders.

More and more variable life policies are being sold in this marketplace, and more specifically for the corporate owned life insurance marketplace. The corporations that are buying these large policies are usually very smart -- they are probably a lot smarter than the insurance carriers that are selling these policies. One of my concerns is antiselection with the general account option in the variable life product. I think there's great risk that corporations will have money in the general account and move it out at an inopportune time to a separate account when the life carrier is most susceptible to problems.

My final comment really is that I don't think any of the carriers, at least the ones that I'm familiar with -- have given very much attention to the AIDS problem. This probably made sense several years ago when most of the sales were to executives, say, age 45 and over. Today, however, if you are selling 25, 30, and 35 year old, you may very well have some AIDS problems, and I have not seen anybody address this yet. Most of the products that I've seen have 1980 CSO guarantees. Although that may have been adequate in the past, I think we have to ask ourselves will it be adequate in the future?

MR. ALDEN L. HEAD: David, in the very last part of your speech you touched on what for me and my company has been a very sensitive item -- which is commission and, as at Provident Mutual, you are a New York company. I'm very interested in what you're doing with level commissions and with the agent selecting his own commissions or the agent negotiating commissions with the client.

MR. REMSTAD: At Northwestern Mutual what we have done is to replace some of our renewal commissions with service fees -- a very small part. Under our corporate policy the agent can choose his commission level, but it's basically based on the mix of term, whole life and single premium life that he chooses. So within the three pieces those commissions are fixed and, therefore, I don't think we've had any problem with New York to date because of that.

MR. EISENBERG: A lot of products out there, as you have said, can drive the commission wherever you want it using cash value enhancement riders or paid up additions rider; or I guess endorsements allow agents to defer commissions and put their money into the cash value. I have never seen any state raise a question, but I'm wondering -- might they? Is it some form of a rebate if an agent can set any commission level he wants to for any particular corporate sale? I don't think there's an answer, but one day we may see some states raise this issue.

MR. REMSTAD: We have no problem getting the contract approved with New York on that basis.

MR. LYNN C. MILLER: We're quite active in this marketplace and I've got a question for Dave on underwriting. Is there a movement in this business to ask an AIDS question or take blood at a certain limit for the guaranteed issue cases? We've been considering that if we're going to underwrite for AIDS, we might as well underwrite for everything and pass on a full commission to the agent. Generally, guaranteed issued is compensated for by lower compensation. I'd like your thoughts on that.

MR. REMSTAD: We don't only underwrite for AIDS, we also underwrite for cancer. We also ask a few other questions such as actively at work, and we only apply this liberal type underwriting to relatively large cases, 25 lives or more. For smaller size cases, it's almost full individual type underwriting.

MR. RICHARD A. MAGRO: I have questions for Rick and John. Rick, as you mentioned in your discussion, FAS 96 has placed a deferred tax burden on COLI, especially leveraged COLI. And while it eventually reverses, it still becomes an issue in the short term and at the point of sale. My questions are: Rick, what policy modifications have been designed to get over this FASB hurdle, and John, how have you presented FAS 96 to your in-force clients who are comparing their original earnings proposals to the new FAS 96 adjusted earnings?

MR. KULAR: I'm not aware of any policy modifications. Presumably the contracts as they exist right now, if par, allow monies to be pulled out by surrendering paid up additions. I'm not that close to it but I can tell you specifically that there are ways the contract can be used to minimize the effect, but I'm not aware of any specific contract changes that have been made to react to this.

MR. EISENBERG: Before John talks, I can say that it seems as if most of the product changes have to do with the cash free return of funds to the corporation through higher death benefits which escape the FAS 96. So death benefit control is where most of the changes seem to be taking place.

MR. JARKA: Getting back to what Steve was saying, if you can swap a dollar of inside buildup for a dollar of claims, you've avoided FAS 96 to the extent that it never shows up on the books. But when you look at where it has actually shown up on the books, it has been in a cash account. So you don't have a FAS 96 concern in what went into the cash account. Very many of the clients that I deal with are willing to be educated, and if you actually can put together a process which goes beyond the policy and goes into the corporation and finds out what happened to the cash when it got into the corporation, you'll find that some FAS 96 strategies just don't make sense economically. You're better off if you have the cash elsewhere and it was created at some point in time by the policy. Then it really should be used to offset the liability. So the liability that's sitting there, that wasn't ever there before and it's $50 million, but if you track what cash came out of the policy in the form of loans, and in the form of death benefits and you track what you did with it, you might have $75 million on the books as a result of having put the policy in. We have some clients who need relief; they can't afford to educate the chairman who is retiring in two years. Those are almost exclusively death benefit increase endorsements and you run into significant underwriting problems. If you can overcome the underwriting problem, you can turn interest into death benefits, either by using an existing dividend option, and you can negotiate a net/net kind of premium rate. But that's about it, you have to turn it into something that FASB won't get its hands on.

MR. MAGRO: I feel like Sam Donaldson here, but can I follow up? On the raise in the death benefits, we've looked at that and it seems to aggravate the interest that they have on the employees lives -- insurable interest. We are concerned that if we take that approach, it will enlighten some eyes that the insurable interest is a question on all COLI policies and not just these policies where you're using extended term or a dividend option. Any thoughts on that?

MR. JARKA: If you watched the hearings in March, I don't think we have to do anything to raise the concerns of the Congress on insurable interest. They know it's there -- they know it's the remaining issue in terms of things that are beyond their control. Currently, Congress has empowered the IRS to only look at 7702 to define life insurance. And it pretty much left insurable interest and all other provisions of an insurance contract to the state. There are some states who have recently, within the last year, passed insurable interest laws which would go counter to what the IRS would like. Georgia and Virginia, for example, say you have an insurable interest in any employee for whom you provide benefits if they've been there a year. But you're going to run into grossly disproportionate arguments. There is a continuing effort with the FASB. The FASB has killed an ant with a club with this thing. But I think more likely than getting relief from the policies, we're going to get relief from the accounting profession.

MR. JESSE M. SCHWARTZ: Since a number of these different marketing approaches are based upon tax laws as they stand right now and since there are some discussions going on, what contingencies, if any, have companies made for the tax law changing the basis of the sale? From the perspective of presenting these concepts to the corporation, what have been the communications that you have been making regarding the possibilities of what will happen if there is a change in the tax law?

MR. JARKA: Interestingly, and I don't always get concurrences from the brokers whom I represent, but I was, in several cases, the first person to notify both the consultant and the corporation who was considering the purchase, that FASB 96 was a very serious concern. This was back in early December 1987. The security of a consulting environment to come out in to the brokerage environment right when everyone said the life insurance sale to corporations is going to fall apart -- Congress is going to close it down. I don't think so -- I think there's a long term relationship that can be developed with a corporation. If you intend to do that, you have to be up front. We have a carrier who will insist on a one year unwind provision because when you look at all the transactions, if there is not an unwind provision and if there is a tax law change, the carrier gets hurt more than anybody. The broker walks away with some compensation, the loss to the corporate buyer is minimal, but the major loser in that deal is the carrier.

MR. SCHWARTZ: So you're saying that the company that you're dealing with has thought about the implication of changes in tax law and as a result they themselves want this one year unwind provision in order to protect them?

MR. JARKA: The insurance carrier, right. Most of the corporations will not only look at those provisions in the tax code that are being challenged but those that might be challenged. We have fall back positions, and we do what we call "crash and burn" illustrations under situations which are as dire as ten years from now. Every corporation says we keep ten years' worth of tax returns open voluntarily. The IRS says it would like us to keep this open; we keep it open. When we hit a disallowance, it's not a three-year disallowance -- it's a 10-year disallowance. Show us a scenario where the IRS deems that we have never had insurance and all the proceeds are gaining proceeds. We have to show them we do some probability adjusting on some of the results but we have to show them every conceivable variation of "crash and burn" on tax law changes, on losing a case in a tax court. From my point of view, it's an extremely complete disclosure process . . . we don't hide anything.

MR. SCHWARTZ: Dave and Rick, what are you prepared to do or what have you thought about doing if there have been changes in the tax law which impact the basis upon which these sales have been made?

MR. REMSTAD: Not that we haven't done a lot of forward planning for that sort of eventuality, I guess we, to some extent, have had our heads in the sand as others do and hope that, while thinking in terms of tax law changes, things do get grandfathered and what's been sold does get favorable treatment. If that doesn't happen, we'll look at preserving the business somehow, just on an ad hoc basis.

MR. EISENBERG: Almost all carriers that I have talked to or worked with say that their largest concern, in the current considerations of Congress with single premium life, is the conservation of business and the grandfathering of business -- much more than what they will do in the future. So far the insurance industry has been pretty fortunate, except for the consumer interest problem on loans a couple of years ago, to always have grandfathering and most of the Congressmen say we'll continue to have it. Obviously, there are no guarantees.

MR. REMSTAD: We have also assumed that any tax law change would include grandfathering. We took a look at potential tax law changes and with our current products we have found that it would still be advantageous to the corporation to fund user insurance rather than some outside site fund for all potential tax changes that we can think of except for maybe inside buildup.

MR. SCHWARTZ: Since you're using a paid up insurance rider, did you take a look at the impact with maybe the payments to date or the purchases to date if paid up would be grandfathered but not subsequent purchases?

MR. REMSTAD: No, we have not looked at that.

MR. SCHWARTZ: The second question I had for Dave was, I thought I heard you mention before that in your illustrations you allow choices of the dividend interest rate?

MR. REMSTAD: We allow current dividend interest rate scale or lower.

MR. SCHWARTZ: So, in other words, they're aware of the dividend interest rate and they can choose that or anything lower?

MR. REMSTAD: Right, and we actually encourage our agents to illustrate at something lower than current scale for the sake of conservatism.

MR. MELVIN J. FEINBERG: Perhaps I need a little clarification. A few of the panelists mentioned that a variable product seems to be somewhat the wave of the future in corporate owned cases. But at the same time, we all know that these cases work from borrowing and leveraging. If you're pulling all the available funds out of the accounts and putting them into the general account as a loan, then what difference does it really make whether its a variable product or not? Isn't it really just in the original illustration where you're maybe illustrating a rate on unborrowed funds that it will make a difference?

MR. EISENBERG: First of all, in the variable products that I was referring to, there was no leveraging whatsoever. They were strictly nonleveraged products. The products were being purchased because some treasurer or corporate finance

officer believed that he could get a better rate of return, if he or his investment advisors had some control of the investments, than the insurance company's general account could give him. Many of these products within the variable structure do have a general account option, and I was only talking about those situations where the corporation has put its money in that general account. As the stock market starts booming and rates start going up, he pulls his money immediately out of the general account and puts it into a money market fund or a stock fund, and the carrier gets caught in a bad disintermediation situation. There was not a leverage situation.

MR. MILLER: I'd like to make a comment about the movement of money from a variable fixed account into the variable accounts. Under any product work that we've done at Pacific Mutual on variable, we've restricted the amount of money that can go out over any 12-month period into the variable from the fixed. I think that's really essential, whether you're dealing in a corporate owned life insurance market or any other market, if you're going to have a fixed account inside the variable, to not let money move in large amounts from fixed to variable.

MR. EISENBERG: That seems to be the basic protection. It's generally a limitation only in one direction, not to the fixed account or from variable to variable.

My final comment is in response to Jesse Schwartz of Mony Financial about there being tax changes that could affect current policy holders and what happens? So far the industry has responded, the actuaries I guess have responded, and some creative brokers have responded to all tax law changes in the corporate environment. We've done some studies recently that show that if interest is not deductible for loans going forward we can proceed either leveraged or non-leveraged. We've shown studies where if the inside buildup becomes taxable similar to the Stark-Radison bill, we can survive. In other words, I think we have some ways around most tax changes. While I think there can be ways of conserving business on the books, it makes future sales obviously much more difficult.

MR. DAVID LEVENE: I'm curious to know in these corporate owned life insurance split dollar decisions, if the people making the decisions very often aren't the people benefitting the most. Very often there may be 30 or 40 highly paid people who are deciding whether or not to make the purchase. The question really is, is there a conflict of interest there and what is the main motivation for the split dollar, for example? Is it the fact that the individuals are getting large cash value insurance at age 65 say, or is it being viewed as a corporate investment?

MR. JARKA: Let me address that because it dovetails into the other question that came up about the variable universal. I worked for ten years in the pension department at AT&T with 16 other enrolled actuaries on staff -- probably larger than a lot of consulting firms. We approached life insurance in split dollar as a pension funding vehicle. It creates security and it creates an interest rate which is nontaxable, so it looks like a qualified pension plan. Variable works very well because as we all know, if we work with pension funding, the contributions are not uniform, the contributions tend to vary depending on the experience year to year.

In most major corporations where compensation is involved at all, there's a compensation committee of the Board that really signs off on the compensation issues of the highly compensated. The primary motivator if you see a book reserved SERP for example, versus a split dollar SERP, you're going to hear that the primary drivers were security from takeover from insolvency. That's really the differentiator. If I'm going to pay 3% yield for security, you're not going to have security. But if I can give you security and make it look like its funded as a pension, I'm going to give it very serious consideration. If you want to get down line and think about concerns, think about the fact that you've given a huge cash value to an executive who is going to draw this down as a pension, and every year he has the option to leave it in as death proceeds or take it out as cash value. Unless you have forced him into some annuitization, you have a very serious antiselection potential. You're going to have the guys who are healthy taking their money in cash and the others leaving it in as a death a benefit. But that's what I've seen driving at and it's taking over the interest of the corporate buyer from the leverage . . . he's blase to the leverage now.