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VARIABLE PRODUCTS UPDATE

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MS. MARY ANN BROWN: As I was thinking about what comments to make, I realized the last session I participated in like this one was on October 19, 1987, in Montreal, and Steve Roth was on the panel. It was Black Monday. I remember Walt Miller recommending that we give minute-by-minute updates on the stock market. We thought that was a pretty funny comment, but in view of what happened at the end of the day, I think it was fairly profound.

Many of you are probably wondering how the stock market decline has affected interest in variable products over the past seven months. We haven't seen much of a decline in interest although new products and projects have decreased somewhat, mostly due to the fact that a large amount of entries have come into the market over the past few years. Many companies are still taking a "wait and see" attitude, which largely means "we'll wait and see if entry costs become cheap enough for us to justify getting into this marketplace." Several types of joint ventures have been emerging for this very reason. Fund, systems or other development costs are being spread over more than one company to try to reduce up-front development costs. Regarding the sales slowdown, we've fielded a lot of questions in this area.

Many people have received some erroneous impressions from various articles published lately. For instance, you may have seen one that talked about single premium variable life sales, particularly those sold by stockbrokers, being down significantly. And that is true. Stockbroker sales are down on life products. But what wasn't mentioned in the article was that variable annuity sales have more than doubled in this market for each of the past few years, and they are more than compensating for the decline in life products as far as total business volume. These statistics are heavily dominated by Monarch's performance. As

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you look at the total numbers, you must realize that last summer, stockbrokers started pushing variable annuities because of tax scares about single premium life. Monarch didn't have a variable annuity to replace these sales. After the crash, guarantees became the name of the game and Monarch didn't have a fixed account option. If you look primarily at Monarch's sales, you realize that there has been a huge decline. Keep in mind that their numbers are huge by life insurance standards; they are close to \$1 billion each year for one product. Having a decline isn't something to draw any great generalizations about.

Meanwhile, we see that variable life and annuity sales by insurance agents are still going strong. They may not be growing at the pace they were before, but they haven't declined in most of the major companies. We see many more companies interested in entering the market. Sales of variable products are much slower to develop, and companies are using a variety of funds and distribution systems. Unlike the situation in the 1970s, products contain quite a variety of investment options, so they can take advantage of the many different investment vehicles and different investment markets.

Other financial institutions, such as banks and mutual funds, are anxious to join with insurance companies to sell variable products, or what they call tax-advantaged mutual funds and money market instruments. Insurance companies are interested in variable products for three reasons: (1) they want to remove the current interest crediting risk -- especially while current rates are coming down and they're losing their spreads; (2) they want to reduce their asset/liability risks; and (3) they want to get more of their agents' business. For all these reasons, together with the growth of equity-linked products into other markets, we think that variable products are here for a long-term horizon.

You will be happy to see that some of the leading players in variable products are on our panel. Steven Roth of Sutherland, Asbill and Brennan, is one of the top SEC insurance attorneys in the country for insurance products. I can attest to his reputation, having had the pleasure of working on many client projects with him. He has been extensively involved in the design and regulatory clearance of variable life and annuity products for the past eight years. Steve will discuss recent SEC and state regulatory developments.

John Hele is a Vice President of Administration at Crown Life Insurance Company in Toronto. He has spent the last five years as a major force in Crown's U.S. division's successful entry into the variable marketplace. He'll discuss the variable market sales and distribution trends. Since John's an actuary and is qualified to discuss profitability of these products, he'll cover that area also.

We also have a name which many of you are familiar with if you read the *Wall Street Journal* and other publications where he's frequently quoted. Michael Lipper is a Chartered Financial Analyst and CEO of several firms which publish and provide advice and research for New York Stock Exchange members. He's an acknowledged expert in the fund field, and is in a position to comment on the variable insurance market from a broader financial services perspective.

MR. JOHN C. R. HELE: I'm an actuary with Crown Life Insurance Company, which is a Canadian-owned stock company that derives 60% of its revenue from the U.S. market. Within the U.S. market, we sell a full range of insurance products, including group, pensions, individual life, and disability income. Through our wholly-owned U.S. subsidiary, Crown America, we sell variable life and variable annuity products. Crown first became involved in the variable life business

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in 1984, and it began selling its first single premium variable life product in 1985. We recently introduced a variable annuity product.

When Mary Ann Brown asked me to give an update on the variable marketplace, I began to review material that she had collected and that I had found in different publications. After looking at this material, it struck me that the variable market today is full of opportunities and challenges. I will discuss sales opportunities, distribution challenges, product opportunities, and profit challenges.

The variable life marketplace is growing rapidly, from 6% of total insurance premiums of \$10 billion in 1986 to 8% of \$11 billion in 1987. Variable life is taking an increased market share. This comes from a Life Insurance Marketing and Research Association (LIMRA) study in which single premium is recorded at only 10% value; the actual premium dollars are obviously much larger. In a study of 32 companies by LIMRA, variable annuity considerations are also increasing, accounting for 33% of all annuity considerations in 1987.

Variable products really compete for consumers' investment dollars against a variety of financial instruments. Let's look at the biggest competitor to variable life and variable annuity products -- mutual funds. From 1986 to 1987 variable products are taking a larger percentage of the consumer dollar. Although mutual fund sales decreased in 1987 to \$191 billion, variable products are now a significant factor in the mutual fund marketplace.

Within the variable life market, a few firms dominate. In a study done by Tillinghast, the single premium marketplace was dominated in 1987 by Monarch with 60% of the market share, accounting for \$1.6 billion of premium revenue; \$1.2 billion was derived through one distribution channel, namely Merrill Lynch brokers. A distant second was PRUCO at \$300 million, and Guardian was third at \$200 million.

In the flexible and fixed premium marketplace Pruco was number one at \$700 million (59% market share); Equitable was number two at \$300 million (27% market share); and John Hancock was number three at \$100 million (7% market share). I think that these 1987 results clearly demonstrate that there is a market opportunity for variable products, especially given Monarch's success with Merrill, and PRUCO's success through Prudential.

Mary Ann talked briefly about results since the market crash, so I looked at what mutual fund sales have been doing recently. Sales have been declining from a high last year, and the only numbers that I could get as of right now were for February 1988. We don't have variable life or annuity sales figures for the first quarter of 1988 yet, but the variable trend is probably similar, especially with the shift from variable life to variable annuity sales.

Variable product carriers may have a difficult year in 1988. The proposed tax legislation, comprised of differing proposals and the lack of grandfathering, is causing great concern among distributors. In addition, consumers appear to be parking their money given the uncertain economic outlook. Leading industry sources indicate that insurance sales may be off in general in 1988. However, the opportunity of a growing market means that variable products are here to stay.

By far, the greatest challenge today in variable products is the distribution challenge. A wise old actuary once said that the three key success factors of

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life insurance are distribution, distribution, and distribution. There are three basic distribution forms that are found today in the marketplace. The first major form is when an insurance company with a limited broker/dealer is selling to national full service broker/dealers with a captive registered agent distribution system. By far the greatest example is the Monarch-Merrill relationship, which produced \$1.2 billion in 1987. The insurance company must keep in step with the distributor or it may be stepped on.

A second successful form by sales is where an insurance company with a broker/dealer and a large captive agency force can try to change the diets of their field force and move them over to variable products. PRUCO and Prudential have been very successful in turning their career force over to the variable product line. You need to have a captive career force that is fully licensed and trained. It is not very easy to change the diet habits of hard core insurance agents. It may take special incentives and a large educational effort.

The third common form which is found today is commonly called wholesaling. Wholesalers and broker/dealers hold all the cards. Insurance companies can be lured by the potential high volumes that these wholesalers and broker/dealers promise. But there is little loyalty to any individual insurance company. As a result, insurance company profits are squeezed. To minimize the sting, a company can create its own wholesaling network. Our firm, Crown America, has followed this strategy. We have developed our own wholesaling network, which sells to regional broker/dealers. There still exists little loyalty at the regional broker/dealer level, but we have taken one player out of the game. This is a very long-term strategy and requires a lot of patience and a great deal of investment on the part of the insurance company.

What are some newer forms that are appearing today in the variable life marketplace? This gets a little more complex as we go along. One is a partnership with your distribution system through reinsurance. This is excellent strategy for your long-term survival, but you're going to have to accept lower profit levels. Monarch recently announced that it is reinsuring portions of its business with Family Life, a subsidiary of Merrill Lynch.

There is another method that is being tried, namely creating your own career distribution system through independent financial planners. The trick is that you must convince them to switch to your full service broker/dealer, who must carry a large array of financial products. To do this, you may have to create a feeder relationship with other insurance companies or other suppliers of security products. This is very difficult to do, but if the company can create this system, it will gain long-term loyalty and have a locked-in distribution network.

A very popular topic today is trying to deal through the banks. The banks, however, will certainly carry more than one insurance company and squeeze you on margins. Remember that they own the distribution system, so they have the key leverage in this arrangement.

Finally, another approach is a marketing broker/dealer trying to put together a series of companies, in terms of relationships, to sell products. This marketing broker/dealer will come in and design the variable life and annuity products for you and help get a financial institution up to snuff in order to sell the products through its own distribution system. This is a very big joint venture, and the broker/dealer takes his profit from a percentage of the sales. It's a very new

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concept in the marketplace, and is quite unproven. I think it is a very interesting development.

The challenge of distribution success boils down to three factors: (1) You have to have large volumes. In this business if you only have one product, and if you're only selling \$100 million, you probably are not going to get sufficient business. (2) I feel you need to have loyalty in some form or another from your distribution system. To do that, you're going to have to have a family of products. Through that family of products, you can have a variety of acceptable margins in which to return a profit. (3) Lastly, I think your distribution system needs to have a financial stake in the well-being of the venture. The successful firms that have sold products to date have met all three of these challenges, resulting in dominant market share.

We also have product opportunities. A typical single premium variable life product found today has a back-end load, with current and guaranteed cost of insurance charges. The asset charges typically total about 1.75%. These loads are quite large when you compare them to other financial instruments, such as mutual funds, guaranteed investment certificates or even annuities.

In looking at typical single premium variable annuity products, these also have back-end loads, policy fees (or sometimes charges as a percentage of fund), and asset charges of around 1.75%. In total, these loads from an investment point of view are lower than loads on single premium variable life contracts. The design limitations imposed by the SEC make investment options and yields one of the major ways to differentiate products.

Basic investment options found in products today include equity funds, bond funds, money market funds, managed funds, zero coupon bonds, fixed account options, and other "new wave" funds such as precious metals, real estate, and asset allocation, which is currently the hottest concept.

What are some of the recent trends that we've seen in products? We've had a flight to fixed accounts. Today, to be successful, it's a given that you must have a guaranteed element to your product. There has been a shift to fixed accounts even within existing products.

The industry is now stressing insurance as opposed to investments with these products. These products are now being touted as wonderful insurance products with an investment opportunity, as opposed to an investment with an insurance rider. I think that the industry in general, as well as in the variable marketplace, is trying to get back to basics -- applying variable products to typical insurance death benefit protection applications.

There has been a renewed emphasis on annuities, and also an emphasis on combination annuities, which have a deferred portion as well as a portion in immediate pay-up.

All recent product trends show an increased awareness of a consumer-tailored approach. This means a product that is designed for your distribution system, the needs and risk levels of the consumer and the correct mixture of guaranteed and variable elements. Opportunities exist for those who are focused on their market and their distribution system.

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By far the greatest and most important challenge in the variable marketplace is "the profit challenge." Profit in variable products typically comes from two major sources: mortality and expense management. That means the loads on the products must pay for the cost of running the business and leave some margin for a return on capital. Typical product returns as they are priced are very capital-intensive with high fixed expenses. The major risk here is the C-2 pricing risk, especially on the expense side, to the extent that you cannot achieve the unit cost you assumed in pricing. AIDS may also increase the C-2 risk for variable life, since it has been typically sold on a short application basis. C-3 risk is now evident in the fixed account, and may be a pricing concern since policyholders have the option to move money in and out of the fixed account.

To even achieve pricing returns assumed in your model, and in order to increase return, one may either reduce the capital invested in this business or increase the earnings. Reducing capital can be achieved by selling the deferred loads on a variable life product to an outside source, which removes this item from the balance sheet. Monarch has recently sold all of its deferred loads to an outside source. Alternatively, you may try to borrow the necessary capital if your balance sheet can hold the debt, and your company can achieve higher returns by using that capital elsewhere.

In trying to increase your earnings, there isn't a lot of leverage here. There are two strategies that go hand-in-hand. You can try to sell more, but you must also automate. This is the way to achieve the economies of scale that you need in this business.

In analyzing profit, I thought it would be interesting to examine the most successful stock company in the variable marketplace -- Monarch Capital Corporation. Based on Monarch's 1987 annual report, sales increased to \$1.6 billion in 1987, with \$1.2 billion of that produced through Merrill Lynch. I think that's quite a dramatic revenue increase in any company. Even though sales have risen, shareholders' mean return on equity has fallen since 1985. Moreover, the return on variable assets dropped in 1987.

What happened to Monarch? According to their president, Monarch invested substantial sums in systems support in 1987. Variable life sales were also 20% below its original estimate of \$2 billion for 1987, and about 12% below its adjusted post-October 19th estimate. It was also diversifying its distribution, and it was the first time that Monarch distributed a variable life policy on a direct marketing basis. These sales were lower than expected. There was a sharp decrease in sales of variable life as a result of the October 19th stock market crash. Monarch had a challenging year in 1987, and perhaps is facing even larger challenges in 1988. It has reduced the capital base by assigning the variable life deferred loads. These actions leave Monarch well positioned to meet the profit challenge of the variable marketplace.

In summary, the variable life and annuity marketplace is full of opportunities and challenges. What can we learn from the variable marketplace? I think it's very important to try to share the up-front investment with the distribution network. It's also very important to focus on the market. You want to make sure that you are going after one market and you will zero in on how you will compete. You can then design products that have appropriate return to your shareholders or policyholders. The third most important point is that you sell large volumes to cover the quite high fixed up-front investment. Firms that can

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meet those three challenges can achieve a fabulous long-term opportunity with a locked-in long term profit and strategic positioning for the 1990s.

MR. STEPHEN E. ROTH: I would like to address a number of areas relating to SEC regulation of variable products. I want to begin with a brief overview of recent insurance company filing activities. I do want to focus primarily on recent regulatory activity at the SEC and the National Association of Securities Dealers (NASD). I also want to briefly address state regulatory developments. As Mary Ann mentioned, there continues to be a high level of company interest in and commitment to the development and marketing of variable products. I look at this from the perspective of the rate of new SEC filings. That rate has remained relatively constant over the past 12 to 18 months. It may still be too early to tell, since many products filed with the SEC since last October were already in an advanced stage of development.

Let's look at the amount of product development that we've seen for variable life. There's been a remarkable amount of development over just the last four years. Four years ago, there were fourteen variable life products with effective registration statements being offered by twelve companies. Twelve of those products were scheduled premium products, and two were single premium products. Today, there are over 100 variable life products with effective registration statements being offered by over 55 companies. Of those products, about 15 are scheduled premium, 46 are single premium (or are marketed in the single premium market), and 38 are flexible premium (or variable universal life [VUL] products). There are five products that I categorize as hybrids, meaning they have a combination of flexible and scheduled features. Finally, there are two products that I put into the category of group VUL.

There are 28 filings pending at the SEC for variable life products, two for scheduled premium, 12 for single premium, 13 for flexible premium and one for a hybrid product. There are currently no filings pending for group products -- but that's a misleading statistic. There has been a lot of interest in the group market recently. Most of that activity, however, has been in markets where no SEC registration is required. There are two such markets which I would like to discuss.

The first is the corporate qualified plan market -- the 401(a) or the 401(k) market. That is a market that's been well developed over the years for variable annuities. This market enables you to set up a separate account only to fund corporate qualified money. There are no prospectus delivery requirements, and no regulation under the SEC's Investment Company Act. This means that the sales load and other design features need not, in any way, comply with the constraints imposed by the 1940 Act. Finally, agents need not be NASD licensed to sell in this market.

The market where there is more interest, at least in my perception, is in the private offering market. That market has been used, or is intended to be used, in the corporate-owned life market and the third-company market and some other group markets. Qualifying for the private offering exemption is a bit trickier than the qualified plan exemption. Generally, one must severely limit the scope and manner of the offering to qualify. The company cannot advertise, publicly offer, or engage in any general solicitation of the product. To avoid prospectus delivery, no more than 35 purchasers who would not meet stringent income or asset tests can buy the product. (Obviously, that's a narrow market -- individuals at the income threshold of \$200,000; and corporations with total assets of \$5

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million, which actually is not all that high.) But in order to successfully design a product that stays outside the federal security laws, you not only want to avoid prospectus delivery but also regulation under the Investment Company Act. In order to do that, no more than 100 purchasers can be permitted to allocate money to a separate account. Depending on the structure, design, and market, the operable limit is 35 or 100. Unlike the qualified plan exemption, agents must be licensed with the NASD to sell in the private offering market.

I'd like to talk a bit about the variable annuity. As Mary Ann said, we've seen a resurgence in interest in variable annuity products, and this is evidenced by looking at the rate of new SEC filings. Since the beginning of 1985, there have been 38 new SEC-registered individual and group variable annuity products introduced into the market by 29 companies. There are currently 28 products proposed to be offered by 19 companies pending at the SEC. The rate at which registration statements are being filed at the SEC during this last year for variable annuities equals or exceeds those for variable life. This really doesn't represent a decline in new filings for variable life, but rather an increase in the rate of filing for variable annuities.

As far as SEC regulatory activity is concerned, it is fair to say that the emphasis at the SEC has shifted over the past year. Through early 1987, the clear emphasis was in developing regulations affecting product design, particularly relating to variable life. During the last year, the emphasis has been more on the regulation of prospectus disclosure, advertising and other issues affecting the marketing and distribution of variable products.

We've also seen increased emphasis on ensuring compliance by companies already marketing products with SEC rules through the SEC's periodic on-site inspection programs. They have recently stepped up the rate at which they are inspecting existing companies already in the marketplace.

As far as product design regulation is concerned, we're really in the last chapter. For variable life, whenever one talks about product design regulation, one immediately thinks about two exemptive rules under the Investment Company Act -- Rule 6e-3(T) and Rule 6e-2. As I'm sure most of you know, Rule 6e-3(T) is a temporary exemptive rule for flexible premium products. It's currently in its second life, if you will. The first version was published in 1984 and the amended version was published in 1987. It is still in temporary form. We expect that a final rule will be published by the middle of June. Don't look for many changes from the current version, it will be mostly fine-tuning. In particular, don't expect any significant changes to the definition of a flexible premium product. You'll need to meet that definition in order to avail yourself of the exemptions contained in the rule. The requirement will most likely remain that no more than 80% of a guideline single premium will be required to be paid in under the contract. Look for a similar requirement for cash value accumulation contracts. Currently the interpretative position relating the requirement to 80% of the guideline single premium doesn't make a lot of sense in the cash value context. But we expect that the same concept will be applied.

Also, don't look for many changes in the complex rules on sales load regulation, especially on increases in face amount. That probably is the most difficult area both to understand and administer. Rules as to the following probably won't change: (1) how much sales loads one can deduct on increases; (2) how to allocate premiums between the basic coverage and each increase in coverage for

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purposes of deducting sales loads; and (3) whether one must offer free-look rights and conversion rights in connection with increases.

One area in which we may see some changes involves more specific rules and perhaps some tightening up on procedures related to issuing contracts and handling premiums. This is an area on which the SEC staff has been commenting to new registrants in the last six months. There will probably be more specific language relating to the timing and procedures to be used in crediting initial premiums and subsequent premiums to contracts.

When 6e-3 is published within the next few weeks, it will most likely grandfather all existing policies. No consents or other amendments will need to be made to existing policy forms. But look for a one-year transition period for current product designs that are continuing to be offered to new applicants. Companies that want to continue to offer a current product may need to amend their product within the year. That will affect some single premium products which are requiring the full 100% guideline premium. It will also affect some products where the amount of sales load that they can take out on increases is calculated in a manner that is not fully consistent with the technical provisions of the rules as they now stand.

Rule 6e-2, the rule for scheduled premium products, remains essentially in the same form as that in which it was initially adopted in 1975. It clearly needs to be updated. The timing of this update is unclear. I think the timing is going to become increasingly important. Through possible tax legislative developments and other market developments, we think we will see more use of Rule 6e-2 than we have in the past few years.

What changes will likely be made to Rule 6e-2? One issue that has to be addressed is to more carefully define what scheduled premium contract is entitled to rely on that rule. In particular, what linkage does there need to be between premium payments, lapse and the existence of a minimum guaranteed death benefit? It's not clear at this juncture whether a product that qualifies under Rule 6e-2 is also qualified under Rule 6e-3. The staff, I expect, will address that issue when an amendment to Rule 6e-2 is published.

An area where I think we will also see some attention is an area that some companies have had a problem with under 6e-2, and that is the inability under Rule 6e-2 to deduct substandard extra charges and incidental benefit charges from the cash value. Recent conversations that I've had with the staff indicate they are receptive to looking at this issue again, and possibly loosening up the rules. Don't expect any changes on the staff's informal limits on risk charges. I think the foregone conclusion is that the SEC will continue to apply the informal sixty-basis-point limit on mortality and expense (M&E) charges assessed under scheduled premium products, while allowing a 90-basis-point charge for M&E charges on flexible contracts. I don't expect to see the changes to Rule 6e-2 published this year. It is possible that we will see something next year and if and when they are published, they will be open for public comment.

I'd next like to turn to disclosure issues and highlight five areas to give you a feel for the kind of scrutiny the staff is giving to this area. Generally speaking, the staff is requiring more detailed prospectus disclosure. Illustrative of that is its approach to disclosing the cost of insurance. Last fall it took a closer look at products that were being offered in the simplified underwriting market.

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In particular the SEC looked at products that were charging more than 1980 CSO rates when simplified underwriting applied. It decided that prominent disclosure needed to be added to prospectuses to disclose the effect of these higher charges. It required disclosure that insofar as a healthy insured buys a policy using simplified underwriting methods, and either now pays or has the potential to pay more than 1980 CSO rates, then that healthy insured is treated as a substandard risk. It also required disclosure of the percentage of the 1980 CSO tables being used. The SEC was so concerned about this that its initial position was that the cover page of the prospectus needed to be amended to add this language, and it needed to be in boldface type. After meeting with individual companies and industry representatives, it backed off. Now the requirement is no longer for cover page disclosure or boldface disclosure, but disclosure does need to be contained in the summary.

Another area relating to disclosure concerns hypothetical illustrations. As I'm sure most of you know, all variable life products in their prospectuses contain hypothetical illustrations and are marketed with heavy emphasis on illustrations. One of the original purposes of variable life illustrations was to permit comparisons between products. But to be able to compare, there must be some degree of uniformity. In recent years the staff has not taken a hard look at illustrations nor has it enforced the uniformity requirements. If you look at illustrations in a number of prospectuses, you'll see different expense assumptions, different premium assumptions, different face amounts, etc. We're now seeing the pendulum swing back towards uniformity. This stems primarily from recent SEC activity that affects mutual funds and variable annuities. It has recently required those products to include in their prospectuses an expense table, setting forth in one location all current charges, fees, and expenses. An expense table is not required for variable life, but the hypothetical illustrations are now intended to serve an additional purpose, to set forth conclusions, if you will, of what would be in the table. This has caused the staff to take a closer look at the assumptions being made in the illustrations. One area in which it has had significant comments in the last two months is the level of operating expenses being assumed for the mutual funds underlying the separate accounts.

Generally speaking, companies have been assuming rates in the neighborhood of 10-25 basis points for underlying expense assumptions. Those are based on the theory that the illustrations run for a long period of time, such as 20 or 30 years. The staff has now concluded that making assumptions on that basis are no longer appropriate, at least after the product has been on the market for a year. Companies are being required to amend their illustrations to take into account current expense levels. This has required companies to raise expense levels from 10-25 up to 50-60 basis points just for operating expenses, with advisory fees added on.

The third area of disclosure is related to advertising past performance. As the book of variable life insurance business matures, there is undoubtedly going to be more emphasis placed on past performance in advertising and marketing. The SEC, in turn, is requiring more detailed disclosure and registration statements about how performance figures are calculated. In order to advertise past performance of the separate accounts in newspapers, magazines or other media, the registration statement must describe in detail how the performance figures are calculated. Generally, if performance figures are included in sales literature and advertising, those figures must be calculated pursuant to formulae prescribed by the SEC and for periods required by the SEC. The SEC formulae require that both yield and total return figures be included, for periods of one, five and ten

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years. A point that is very important in the variable contract market is that the SEC has publicly stated in a release that it is misleading to advertise underlying fund performance in the contracts of variable life products without also showing performance for the same period at the separate account level, reflecting additional separate account charges.

Tax disclosure is a fourth area; the staff has not gotten very involved in it, but it is *nonetheless* a very important one. Companies are including more detailed and more qualified tax disclosure in their prospectuses. No doubt this is in some measure in response to recent legislative activity. But it also reflects increased sensitivity to the fact that there are no regulations under Section 7702, and there are a number of product design features where there can be no certainty under Section 7702.

The final point with respect to disclosure relates to the registration form that governs the prospectus in general. Right now, there is no form specifically tailored to variable life products. The disclosure requirements come from outdated general forms, from SEC informal positions, and from industry practice. This leads to a complicated, long and cumbersome prospectus that is difficult to read. It's long overdue that a variable life form be developed. The staff has shown some interest in this and has raised the level of priority of this project. It has asked the ACLI and others to prepare a proposed form and a task force has been formed to do so. One can assume that the form will take the same kind of structure that we now enjoy with variable annuities and mutual funds, namely a two-part registration statement (a short-form prospectus and a statement of additional information).

Before I talk on state regulatory activity, I'd like to speak on one other SEC regulatory development which relates to confirmation procedures. Generally speaking, one of the consequences of registering a product with the SEC is a requirement that all purchase and sale transactions be immediately confirmed by the broker/dealer involved in distributing the product. The variable life insurance industry has enjoyed significant exemptions from that requirement; companies do not have to confirm, except annually, either premium payments or monthly deductions. The staff is now rethinking its position on this issue, and is looking at the possibility of requiring all companies, regardless of product design (scheduled or flexible premium) to move to a quarterly confirmation procedure. Quarterly confirmation procedures would essentially require a transaction-by-transaction summary of what occurred in the past policy quarter. Premiums, whether they were scheduled or unscheduled, planned or unplanned, would not have to be confirmed immediately, except in the quarterly statement. Transfers, loans, loan reallocations, and other voluntary types of transactions would have to be confirmed in addition to sending out the quarterly statements.

As far as state regulatory developments are concerned, we are seeing continued progress. Virtually all states now permit the sale of flexible premium or VUL products. In California, while the logjam is broken, it still is an incredibly long process, but policies are being approved. California has proposed refinements to its variable life certification form through a bulletin that was recently published. Those refinements significantly ameliorate the burden of answering a number of questions that not only are difficult to answer, but the answers just don't come out right. North Carolina had placed a moratorium on the offering of the VUL in that state. In late December it lifted that moratorium. Filings are now being approved, but special disclosures are being required and monthly reports are being required if the policy does not provide a minimum face amount.

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Most policies don't fall under that requirement. Basically, North Carolina can be put in the category of a model regulation state at this juncture.

Action still needs to be taken in two states -- Massachusetts and Michigan. In Massachusetts, an industry group has been meeting with the Department to discuss and comment on draft revisions to the Massachusetts regulations. Progress has been made there, but as of yet there has been no formal publication of an amended regulation. In Michigan the process is virtually complete. An amended regulation very close to the 1982 model is now before the Rules Committee of the Michigan legislature. Once the Rules Committee acts on the regulation, companies ought to be able to obtain approval in Michigan with little difficulty.

An area where regulatory action may be necessary in some states relates to group products. The 1982 model does not specifically address group products. Not all group product designs have a problem under the existing regulation. However, some group products may; special relief may be necessary in order to offer a group VUL product.

I'd like to finally talk about variable contract distribution and three regulatory developments. These relate to the manner of distribution and the nature of the amount of compensation that can be paid in connection with the distribution of variable life and variable annuity products. This activity has emanated from both the SEC and the NASD.

The first area relates to Rule 12(b)-1. As I'm sure you know, public mutual funds can charge fund assets for distribution expenses, provided they get director and shareholder approval for the so-called 12(b)-1 plan. The level of fees charged against fund assets varies anywhere from 25-125 basis points. The SEC staff, however, in the context of variable insurance products has steadfastly taken the position that Rule 12(b)-1 plans cannot be adopted and implemented. This position stems from the staff's longstanding concern about mortality and expense risk charges, and the use of amounts derived from these charges to cover distribution expense shortfalls. Few funds underlying variable products have gotten the Board of Directors to approve these plans. No one has yet implemented the plan, although one company is seeking a special exemption to do so. At best it is unclear whether the SEC will grant the exemption. The inability to assess Rule 12(b)-1 fees, together with the SEC staff limits on M&E risk charges, can have a limiting effect, of course, on the ability to pay trail commissions.

The other two developments emanate from the NASD. The first relates to supervisory practices and procedures of insurance companies and all broker/dealers. In the middle of last year, the NASD issued a notice whereby it proposed more specific on-site supervisory practices and procedures for all broker/dealers. Because most insurance companies supervise their operations through a centralized structure out of the home office, any proposal for on-site inspection would have been very burdensome, if not unworkable for many insurance company distribution systems. Most importantly, the proposal would have required that in any agency location with four or more agents in residence, at least one of those individuals would have had to be licensed as a principal. This meant that one of those individuals would have had to pass an additional NASD exam; it would have resulted in a dramatic increase in the number of principals in a typical insurance agency distribution system. The insurance industry objected to the breadth of the proposal, and argued that the limited nature of the typical

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insurance broker/dealer -- limited insofar that most agents only sell mutual funds and variable contracts -- made many of these on-site supervisory requirements unnecessary. The NASD was receptive to the industry's comments. In February 1988, it issued a revised proposal which represents a much more flexible approach. It still requires a number of changes to many broker/dealer procedures. More detailed written supervisory procedures and compliance manuals will have to be prepared by many companies. There must be one person designated for each location to be responsible for supervision and compliance. But that person need not necessarily be a resident at that location. The person need not necessarily be a principal; he can be a registered representative. Each agent must be assigned to either a registered representative or a principal who is specifically responsible for the supervision of that agent. Each agent must have an annual compliance interview or meeting with the management of the broker/dealer.

It's likely that this rule, or something very close to what I just outlined, will be in place by July. Since some time is going to be necessary in order to come into compliance with these requirements, it appears that the NASD will be willing to grant a grace period until the beginning of 1989 for full compliance with the rules.

The last issue relates to the payment of noncash compensation. In early March the NASD issued a proposed rule amendment which would prohibit payment of noncash compensation in connection with the sales of variable contracts and mutual fund securities. Noncash compensation was very broadly defined to include any travel expenses, merchandise, awards or prizes. Generally, it would permit such compensation only if directly paid by the supervising broker/dealer, and not directly or indirectly paid by the issuer or any other broker/dealer who does not have direct supervisory responsibility for that particular agent. The effect of this proposal would be to severely limit and in many cases prohibit many insurance companies' noncash compensation arrangements. They are often either directly or indirectly paid by the insurance company, which in this case is the insurer, and not by the affiliated broker/dealer, which is often a company that is only minimally capitalized.

Industry trade associations and individual companies have commented on this proposal and have urged the NASD to take a position similar to the one it has taken for many years with respect to the payment of commissions. That position basically is that commissions can be paid by the insurance company to the agent, provided the broker/dealer is responsible for the supervision and control of the agent from a security standpoint. The comment period is closed and there has been no development or response from the NASD, so it's difficult to tell where this proposal is going.

In conclusion, there continues to be a significant number of regulatory developments affecting variable products. As I've indicated, the emphasis has shifted somewhat from product design to product disclosure and distribution. No one can deny that the regulatory hurdles associated with the variable business are significant. But in a sense, the environment from a regulatory standpoint has never been better. No doubt careful planning is still necessary, but in my view there are few, if any, insurmountable obstacles. One could not say that a couple of years ago. Certainly the regulatory structure is not perfect. It is complicated and cumbersome. The rules of the game, however, are clearer than they have been for some time. The amount of time necessary to bring a product to the market, while still significant, is not as long as it was a couple of years

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ago. As the market and products continue to evolve, regulatory issues will continue to arise. Hopefully, when those issues do arise, the dialogue between the industry and the regulatory committees that has characterized the last five years will continue to serve as a model for solving those problems.

MR. A. MICHAEL LIPPER: Who owns a money market fund? (Would you call it 40%?) Now who owns any other mutual funds? (All right, again it's about half.) How many of you own a variable product? (I see that there are very few believers.) Now here comes the critical question that I need answered. How many of you have personally paid a commission to buy a competitor's product? This is your problem. You don't believe in your own products, at least to a significant degree.

Because of that, I need your help. I need your help because I've told people to enter the variable field. In the U.K., 60% of life insurance sales are unit-linked. On that basis, I'm on the hook suggesting that the variable field, in terms of assets, will someday be worth \$200 billion, which is approximately ten times the current level. I'm going to need a lot of help from everybody out there. You and your companies had better start to believe.

I think that I can give you some reasons to believe, if you start looking at the mutual fund industry as a model. The mutual fund industry's growth has been spectacular in just the last few years. The mutual fund industry has benefited from a number of things. The first is visibility. There has been an explosion of both business and consumer press who regularly write up mutual funds. In your field, to the best of our knowledge, publications that pick up data on variables are the *National Underwriter* and the *New England Insurance Times*. Those are the only two that report performance on a regular basis. *Barron's* picks up unit values weekly. This is the first time that there has been any public listing of unit values. One of the reasons that we think that unit values should be published is because of the consulting we do on 401(k) plans. One criteria that multiplant and multilocation 401(k)s use in selecting options that they will offer is whether the employee can look up a number in the paper. They don't want the employee calling the employee benefit office saying, "How am I doing?"

The next item is another for which I think you can use the mutual fund industry as an example. With the mutual fund, look (and the key word is *look*) simple. It is simple to understand. You have made it an art form to try to understand your products. No two of you will agree about any single product. It is probably the best thing you can do to defeat your marketing efforts. I think that the insurance industry has to get over this.

I'm arguing for simplification, which is a term. The politicians have done this brilliantly. If you remember, the last tax act was called the "Tax Simplification Act" and was 600 pages. I am saying that I think you can make your products look simpler. I'm not suggesting changing any of your economics, even though I question whether you will hit your potential if your total loads are as high as they are. My real message is that products look so complicated. If you can simplify, I would suggest that you do so. I'll attempt to show you how complex we in the investment world have found variables.

We have turned to Mary Ann's firm to help us understand variables. We are testing a new product which analyzes products out there. We need lots of help to try to understand this market. If we have to go through that effort, can

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you imagine what your consumer has to go through? Remember also that consumer education is growing in this country. People like to compare.

There is significant risk in performance advertising. The first risk is that you'll get bad business. This business won't understand the risks within the product, and will leave you. The second risk is what happened to the mutual fund industry, namely that you will bring on undesirable regulation. The classic case in the mutual fund industry is the new yield calculations, which don't work and will have lots of problems behind them. It was brought on by a few groups taking advantage of what they could call yield. While I think that using competition is useful, somebody better make sure that the claims don't get carried away. That is especially true for you who are not fully in this industry. Let me define that. Those who are not fully in this industry are those who ranked below number four in industry sales last year. Anybody who is not better than fourth as of last year should think about joint ventures with those in the mutual fund industry, not because of their superior investment skills (that is arguable), but because of their marketing skills. Many of these groups have done more with less than most of you.

I also would suggest that you look at a couple of things barely on the horizon. Shearson evidently is taking the wine garden position out of First Capital Holding. The key asset in First Capital Holding is the old Hutton Life. Shearson is clearly paying a premium over book value. It doesn't do that in a cavalier way. I think that what you've seen with Merrill and Monarch was the tip of the iceberg. Shearson has more capital than Merrill. Prudential has more capital than Merrill. This is why I say if you're not fourth, watch out. This will become a capital-intensive game.

The other thing that I don't think you are taking full advantage of is something that we see overseas. This is not something in the off-shore funds, but something called an umbrella fund. This is a single fund that has numerous sub-funds and various investment objective types. The key from the tax standpoint is that you don't pay taxes on a switch.

A great disadvantage in various asset allocation strategies pertains to the taxes resulting from making switches. You don't have to do that in your variable products. Yet I don't see that listed as a primary benefit. To me, this is the most significant advantage that you have. There are any number of investment strategies that we have looked at for individuals. By the time you wind up paying capital gains taxes on the switch, however, and think of it over, say, a ten-year period when you make three, four, or five switches, you wind up with a lower result than if you took a medium strategy buy-hold all the way through. If you don't have to pay taxes on an intermediate basis, you are not reducing the capital that the investor has.

You can make a very strong case for a real asset allocation approach. By the way, you will not be able to make the same case in a pure mutual fund. These are essentially the views of an outsider who needs your help to get the assets of this industry moving up by a factor of ten.

MR. LYNN C. MILLER: Steve, there has been a lot of discussion on diversification and control issues. Specifically, can you comment on whether it would be advisable for a company to pursue a fund whose investment strategy was to perhaps mimic an S&P 500 Index?

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MR. ROTH: I assume that you are referring to possible tax regulations related to investor control. I have not heard that the S&P fund is the one that is being focused on. I have heard that there is more concern about the number of funds under the particular product and the ability to switch between funds on an unlimited basis without charge. I have not heard that the S&P fund was problematic.

MR. MILLER: You mentioned distribution strategies. Would you care to comment on what I see as a potential opportunity for companies that wish to broaden their distribution by searching out other insurance companies who don't have the resources, or the capital or the administrative systems to develop their own variable products, but need a partner that can develop a product, administer it, or manufacture it for sale through their own agents, with reinsurance perhaps tied in?

MR. HELE: Perhaps Mary Ann can help out here too. I think that there is going to be a trend within the industry, as companies have to join together to get the proper economies of scale. This business is becoming a little easier from the SEC side, but I think many firms have only seen the tip of the iceberg from the compliance side.

As the NAIC and the SEC come in to audit, I think it will be a real shock to a lot of insurance agents as to what they'll need to do. One cannot go out and talk about a new product until he has a prospectus. Many firms would do well to band together, but as you band together, you must be very careful from the compliance side.

MS. BROWN: That is a very good question. We do see a lot of interest in the market from nearly every client having the desire to share expertise with other companies to help reduce overhead. Unfortunately, it is hard to get this done because it is very difficult to get through the red tape. It just adds an additional burden to the already heavy regulation. We haven't seen as much development as we will in the future. Companies like yours have gone through the process and then have had time to retrench.

Many of you are probably aware that Integrity has such a venture available. There are two ways you can go, one being the use of generic products, which are their products. Most companies do not want to do this because they want to private label their product. There is a great deal of the ownership instinct there. In the future, there will need to be greater flexibility in the product design.

MR. JOSEPH F. KOLODNEY*: Just to take the last comment first on joint ventures and reinsurance, New York has just come out with a proposed regulation on agent-owned reinsurance companies. They are regarding that now as compensation in violation of current New York regulation. I suspect that probably would apply to your broker/dealer distribution network that would be getting the compensation. I don't know how it would affect individual company-to-company transactions. I think that this kind of regulation would probably have some kind of an impact on the actual distributor.

* Mr. Kolodney, not a member of the Society, is President of Presidential Life Insurance Company in Nyack, New York.

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I may be misunderstanding the thrust of the points raised here, but are we gliding over one of the factors that enamored everyone of variable insurance products in the first place, which was to pass the investment risk to the insured and sit back and reap the M&E charges? And if you can participate in the investment advisory charges, all the better? Are we cheapening the product again? Someone told me that 75% of new sales on variable annuities have fixed bucket options, which means in effect that they are buying a variable annuity but saying to the insurance company, "You are taking the investment risk." The insurance company loses because that money comes right out of the separate account into the general account, so you can't realize the M&E charge on that.

