RECORD OF SOCIETY OF ACTUARIES
1990 VOL. 16 NO. 3

LIFE PRODUCT DEVELOPMENT UPDATE

Moderator: CHRISTIAN J. DESROCHERS
Panelists: JOHN T. ADNEY*
TIMOTHY C. PFEIFER
MARK A. TULLIS
Recorder: CHRISTIAN J. DESROCHERS

- o Variable
- o Last survivor
- o Single premium life
- o Participating products
- o Term insurance
- o Tax
- o Regulatory

MR. CHRISTIAN J. DESROCHERS: Before I introduce the panel, let me describe what we're trying to accomplish in this session. We've divided the presentation by product type. For each of the product types the panelists will discuss the state of the market; what products currently are being sold; and why we believe they're sold. We will share with you any new plans and ideas that we see; and finally, we will discuss regulatory developments.

We have three distinguished speakers. The first panelist is Tim Pfeifer. Tim is employed with Tillinghast in its Chicago office. He is currently the editor of the *Product Development Newsletter*, and is active in the Tillinghast product development practice.

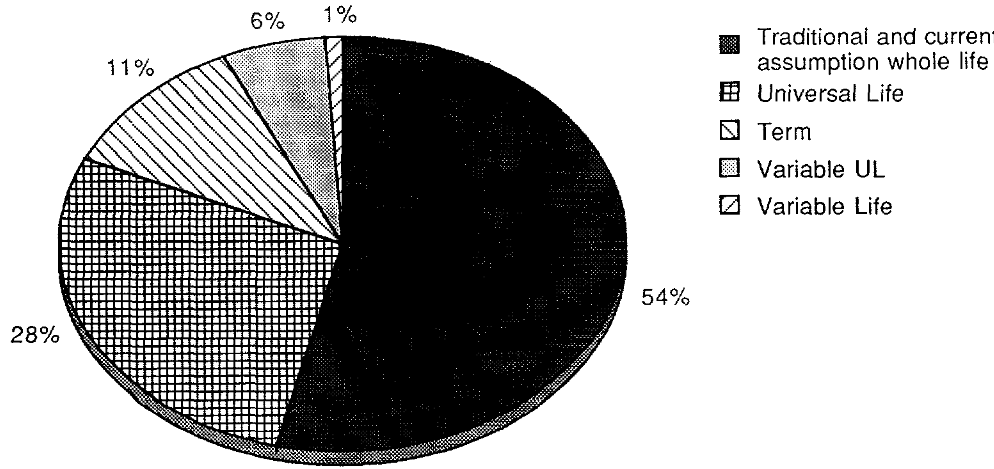
Mark Tullis is also a consultant with Tillinghast in Atlanta, also active in the product area. Our third panelist is John Adney. John is managing partner at Davis & Harman, a law firm in Washington, D.C., and is currently the chairman of the American Bar Association (ABA) Insurance Company Tax Section.

MR. TIMOTHY C. PFEIFER: I'd like to take the topics in a little different order than Chris mentioned. I'd like to start with the term insurance market and make a general observation on term insurance market share. These data are based on some recent Life Insurance Marketing and Research Association (LIMRA) statistics. As a general observation, the role that the term insurance business has played in overall life market share has been fairly stable over recent years. The figures shown in Chart 1 for 1989 are on a premium basis and indicate that term production represented roughly 11% of new life premium last year. The major observation on the premium side over the last few years has been the shifting of business on the permanent front more so than on the term side -- traditional and excess interest whole life (EIWL) recovering market share from universal life (UL). If we look at market share on a face amount basis, term business is

* Mr. Adney, not a member of the sponsoring organizations, is Managing Partner of Davis & Harman in Washington, District of Columbia.

CHART 1

1989 LIFE PRODUCT MARKET SHARE
By Premium



Source: LIMRA

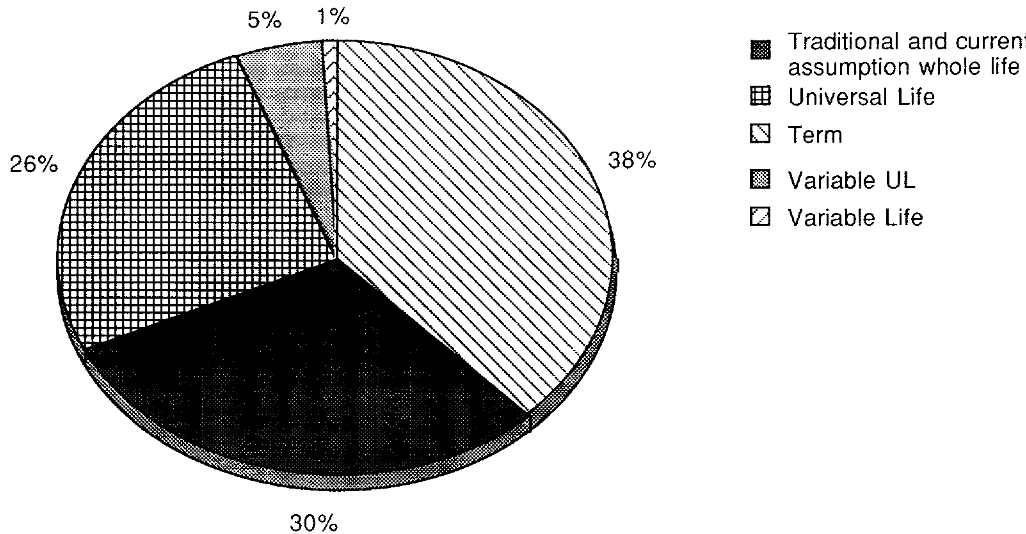
much more predominant. Term insurance represented 38% of the overall life face amount issued in 1989 (see Chart 2). Finally, if we were to look at it on a policy count basis, term insurance would represent 18%, and as I mentioned, that contribution from term insurance has been fairly stable over the past couple of years.

Now let's look only at term production, specifically the term contracts that are being sold by various companies. These figures are based on a LIMRA survey. Roughly 65% of the term products currently sold are nonparticipating with indeterminate premiums. Oftentimes, these products define guaranteed maximum gross premiums in excess of valuation net premiums in order to obviate the need for deficiency reserves. Twenty-five percent of today's term contracts are nonparticipating with fixed premiums, and 10% are participating. Given this snapshot, I'd like to discuss what we see as some of the product trends that are taking place in the term market. What we've seen of late in terms of hot products are the 5- and 10-year level term, and in some cases 15-year level term products. I think this reflects a couple of things. First, customers' preferences for more fixed level premiums, and second, some discomfort on the part of many companies with the ART market with respect to ART persistency and profitability. That's not to say that ART is not still popular, however. Studies show that over 50% of companies questioned in a recent survey sell some type of ART plan, either an aggregate ART or a select and ultimate ART, and that percentage was far and away above any of the other types of term products. I believe that most companies feel it necessary to have some type of low cost, pure death benefit type of protection in their portfolio, and ART meets that need.

Recently, I believe that aggregate ART products have been more popular than select and ultimate ART products. Again, I think there is some concern on the part of many companies with the persistency of select and ultimate ART, and maybe just a general discomfort with the level of the initial rates. Accordingly, we see a movement back towards aggregate ART approaches. Chart 3 shows the four main classes of "term business." Attained-age ART is represented by the first cluster of three bars, the second cluster represents select and ultimate ART, the third represents graded premium whole life, and the fourth level renewable and convertible term. Chart 3 illustrates the overall proportion of sample term portfolios that is represented by each type of term product. This is based on a term study that my firm produces. The individual bars in each cluster reflect three different points in time of the term study. The third bar in the cluster represents November 1989 results, the middle bar November 1988 results, and the first bar represents May 1988 results. As you can see, the relative importance of the level term business is increasing while the ART and the graded premium whole life is showing a drop off. This isn't to say that this particular term study is a mirror of the whole industry, but it should provide us with a pretty good idea, since it has a large sample size.

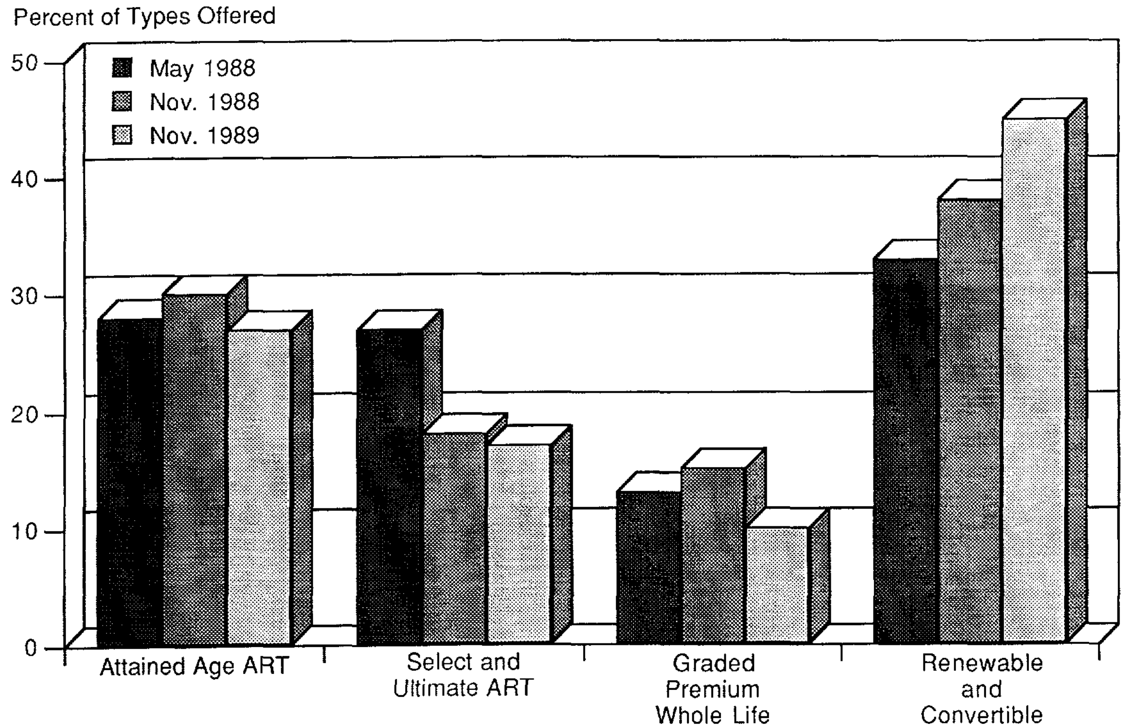
Another thing that we see happening on the product side is very little activity in decreasing term business. I think many companies have found that their cumulative ART rates for a level death benefit are lower than the corresponding decreasing term rates for a policy with the same initial benefit, but with a decreasing future pattern. The companies that seem to be most active in decreasing term insurance are life affiliates of property/casualty companies that have tried to take advantage of homeowners' sales.

1989 LIFE PRODUCT MARKET SHARE
By Face Amount



Source: LIMRA

COMPOSITION OF TERM MARKET
Product Trends



Source: Tillinghast Term Study

Other companies have attempted to sell very flexible types of term plans under a variety of names that have met with varying degrees of success in the market. Typically, though, it boils down to the fact that it's the rate that's important, and all of the other features that a term plan might have are really secondary.

As one final observation about product types, we have run into some companies that are still very gun-shy about the term business. They're hesitant to enter the market due to fears about Guideline XXX, and the impact that guideline may have on their financials, as well as a lingering concern about AIDS.

I'd like to offer a few observations on term rates. In general, term rates have been declining very modestly. I guess one could argue that there isn't much room for them to precipitously decline any more. I think, however, that some companies have had some of their concerns about AIDS eased. This is not to say that they don't feel that it's a potential problem any more, but rather that some concerns about their ability to underwrite AIDS effectively are reduced from what they were a few years ago. Competition is still tough, and I think competitive factors have led to a general trend in declining term rates. On the select and ultimate ART front, select rates have tended to come down while ultimate rates have been bumping up. I also think that there's a general movement toward longer guarantee periods for the current rates. Companies are continuing to develop preferred underwriting classes and other types of super select classes with very attractive rates if the applicant can meet various underwriting criteria. Another trend we see is that companies are very interested in how their products are going to compare in the professional quote service market. They've gotten their hands on some of the surveys that have been done by these professional quote agencies, and are concerned about how their rates are going to be viewed in the marketplace.

Chart 4 is from the same term study and shows the trend in the initial rate per thousand for three different types of term plans at three different points in time. These are median rates from a sampling of a couple hundred products. The top line represent stepped premium term plans, the middle line represent attained age ART, and the black line, select and ultimate ART. As you can see, over this roughly 1.5-year period, term rates have generally sloped down, although not at a dramatic rate. The biggest decline probably has been in stepped premium term rates which are becoming more competitive.

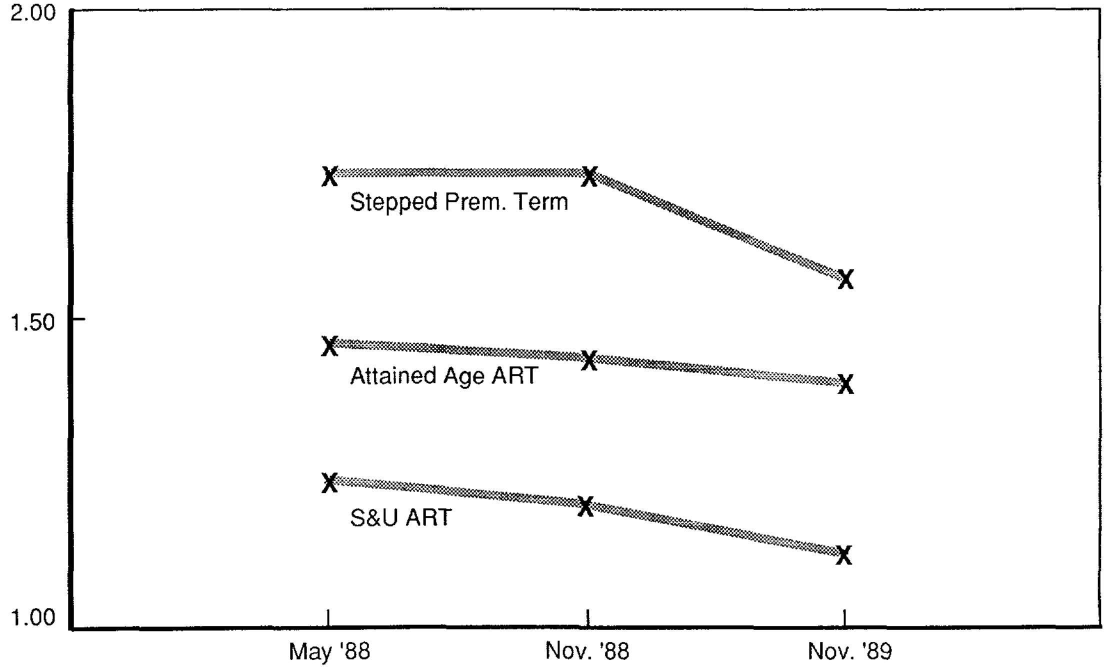
A couple of other observations along the lines of design trends are that more and more companies are looking toward preferred smoker rates. These are awarded based on an applicant's ability to satisfy certain underwriting criteria such as family history, blood pressure, build histories, life-style, and so on. These rates tend to be in the neighborhood of 10-20% lower than rates for the standard smoking class, but usually are still lower than a nonpreferred nonsmoker.

Companies are continuing to develop products with conversion credits. Over 50% of the companies in a recent survey offered some type of conversion credit. One might ask how successful conversion credits are in encouraging conversions. LIMRA recently reported that the conversion frequency, for all companies combined, is roughly 8% on average per year. I suspect that most companies do not build in explicitly the cost of

CHART 4

TERM PRODUCT TRENDS
Rate History

MEDIAN INITIAL RATE PER $1,000



Source: Tillinghast Term Study

conversion when they price their term business. If conversion credits become more prevalent and are able to generate a greater amount of conversion activity, the actuary may need to address this cost in future pricing.

The typical conversion credit feature allows for the policyholder to reduce the going-in premium on the plan converted to by an amount that could be expressed as say, X dollars per thousand issued, or it may be defined as the annual term premium paid in the last 12 months, or it may be the last five years' premium paid on the term business, subject to some cap. There are a variety of different alternatives. It's not uncommon for companies to make the conversion credit decline with time also. In other words, insurers try to encourage conversions up-front either by giving a larger conversion credit in the early years, or by making commission arrangements to the agent more attractive in the early years.

Prepayment discounts are also popular. These are means by which companies hope to improve persistency on term business, which is a pretty noble goal when you consider that the average lifetime for a term plan is about three years. The idea behind prepayment discounts is that a customer would prepay at issue maybe three or five years' premiums. The lump sum paid at issue would be less than the sum of three or five regular premiums. If the policyholder lapses shortly after making the prepayment, he/she loses the prepayment. If the insured dies, some unearned amount is refunded normally. If any interest is credited to the amount that has been prepaid, it would be considered taxable income.

Some companies approach this in a different way by trying to encourage persistency by changing premium mode factors. On their monthly pay plan, for example, insurers may try to either eliminate the monthly mode entirely because it tends to be the mode that spawns the most lapsation, or they may raise modal factors to such a high level that it's economically a raw deal for policyholders to buy the monthly mode.

Let's talk a little bit about underwriting practices. It's quite common in the industry now for blood profiles to be taken at $100,000, and in some geographic regions, they may even be taken at $50,000. With the high minimum face amounts that one sees on a lot of term business, that can mean that a company's entire term block is being blood tested.

One of the major regulatory items concerning term products is Guideline XXX, which is an actuarial guideline proposed by the NAIC that would potentially increase reserves on some types of term insurance and graded premium whole life. What is it and why is it?

Guideline XXX is an update to Actuarial Guideline IV, and would affect any plan with no cash values in the first 10 years. In order to be impacted by Guideline XXX, a policy doesn't have to be term; it could be some other form, the name is really irrelevant. The key characteristic is the lack of cash values in the first 10 years. Guideline IV, which would be updated by Guideline XXX, would prohibit the use of unitary reserves, which are really the reserves defined in the Standard Valuation Law, where valuation net premiums are a constant percentage of the gross premiums. Guideline IV prohibits the use of the unitary reserve method specifically for increasing premium 1958 CSO term plans without cash values. Instead, it requires that companies calculate reserves on a period-by-period basis, where the length of the period is the duration of time when the premium remains level. That would be one year in the case of ART, or five years in a five-year Renewable and Convertible (R&C) term. Guideline IV also advocated additional deficiency reserves in the case where the net premium is larger than the gross premium. Guideline XXX, originally exposed by the NAIC in 1988, would include 1980 CSO plans under its umbrella, and again applies to all plans with zero cash values in the first 10 years. Guideline XXX emerged from a concern that companies that develop sharply increasing premium plans could be funding present and past costs with future premiums, and for a long period at the outset of the plan could have zero terminal reserves.

Guideline XXX, in its original form, proposed the "unified approach" where reserves would be calculated on a period by period basis, except that companies would have to group periods together if the grouping resulted in larger reserves. Guideline XXX was postponed in 1989 due to industry objections related to the retroactivity features of the guideline; the fact that it was viewed as being contrary to the Standard Valuation Law; the fact that loopholes still existed in Guideline XXX; and the fact that it would affect plans like decreasing term which really weren't meant to be captured under the guideline.

At the NAIC's Baltimore meeting in June 1990, an industry task force set up as a result of postponing XXX reported its interim recommendations, and its members have submitted these to the Life and Health Actuarial Task Force, which is studying them right now. The goal is to have a final report from the industry task force by September 1990. The tentative conclusions that the industry task force arrived at were that the basic reserves on this type of business should be the greater of reserves calculated on a unitary basis (where the mean reserve has a minimum value of $1/2c_x$) and reserves calculated on a period by period basis. The industry task force also advocated that lower selection factors be used for the 1980 CSO mortality table, and also that deficiency reserves should be calculated on a basis lower than the 1980 CSO. There's been no precise definition of what the new selection factors should be or what the new table should be. (These conclusions by the task force were based on a comparison of natural benefit reserves for six sampled term-like plans to several different potential reserve bases that might be adopted under Guideline XXX.) At this point, it's not entirely clear how tax reserves will be affected by this, and it's safe to say that there's still a long-tail on Guideline XXX. There's a lot more work to be done, and I don't think that we can expect a final reserve standard anytime soon.

Let's shift from term to participating products, and in this area, my opinion is that there are not as many product innovations going on as in second-to-die or term products. The market share for participating products has been gliding upward in recent years. Some reasons that have been put forth as to why participating permanent business is staging a comeback are (1) general declines in market interest rates, (2) the stock market's problems, especially back in 1988, which led to some disenchantment with variable contracts, and (3) the fact that UL illustrations have been receiving bad press among the general public.

The need to revise products to comply with the 1980 Amendments to the Standard Valuation and Nonforfeiture Laws gave companies the opportunity to take another look at their participating business, and to institute some unique new product features. The tax law wounded single premium whole life (notice that I didn't say killed it), and has moved many away from the single premium life business. On UL, there have been some profitability and persistency concerns that I'm sure you're aware of. I think there's a general affinity by the industry to think that we're going back to basics, and many people view participating type business as a move toward basics.

In terms of some of the cost trends that we're seeing on participating business, traditional participating whole life has historically had problems competing with universal life business vis-a-vis up-front premiums. Over the course of a policy, costs might compare very favorably, but up-front the UL could show a low target premium. Participating business had to come in with a higher gross premium early, with the prospect of dividends later on. In recent times, we've seen more use of term riders and paid-up additions that have been attached to participating policies to reduce up-front premiums. Competition, as a result, is heading toward a keener interest in that going-in premium. We've even seen substantial movements of companies competing on the basis of vanishing premiums, and how long it takes to vanish premiums on a participating whole life plan. In some cases, companies will charge very low initial premiums with increases scheduled for future years, and leveling off thereafter.

In terms of dividend scales, my impression is that dividend scales are not increasing, but instead they're stabilizing somewhat. We're not seeing the free falling that we have seen in the past, but generally dividend scales are fairly stable.

Some other developments on the participating front are the use of riders to be attached to participating business, not only long-term care and dread disease riders, but also the beneficiary purchase options which we'll cover when we talk about multiple life plans. These can be used as an alternative to a second-to-die plan and have also realized some renewed interest because of the general interest in last-survivor business. The participating business is also facing some of the same issues that universal life did in terms of illustrations, specifically the issue of illustrations versus histories, and the debate of which is the appropriate basis for sales presentations to a customer.

Preferred classes are emerging on participating business, too. Companies have also moved toward using a smoker/nonsmoker distinct valuation table in order to lower premiums on nonsmoker business.

I'd like to turn now to the second-to-die market. If there's any product line right now that is hot and is generating a lot of interest, it's the second-to-die market. Although I was asked to talk about multiple life plans, today that really means second-to-die products because the first-to-die joint life business is definitely not capturing the attention of the markets as are second-to-die products. Second-to-die plans are popular products these days. They meet the needs of a generally aging population, with the growth in estate values and a need to protect assets upon the second death. This plan is used most popularly in estate planning situations, although it doesn't have to be used in that way. There are an estimated 7.5 million households in this country with estates over

$1 million. We're seeing one of the largest intergenerational transfers of wealth in some time. The market is generally characterized as a competitive market with wealthy, sophisticated buyers. I think that's generally true, although I don't believe that buyers are necessarily as wealthy and sophisticated as many believe. It's quite easy for a typical individual to own an estate that could qualify him for an estate tax need. Use of second-to-die products in estate planning situations has been made feasible by the unlimited marital deduction (when you have a spousal situation), but it's also used heavily in the business world in split dollar and key man situations. Companies are also finding that second-to-die policies can be marketed in other situations, such as those cases involving parents of handicapped dependents and charitable giving situations, or simply where one tries to take advantage of the tax deferral opportunities on two lives.

Let's talk a little about the market. It's difficult to pinpoint exactly the size of the second-to-die market. We're not aware of any hard and fast production data. The number of insurers entering the market is growing rapidly, compared to just a few years ago. There are at least 40 companies now on the street with second-to-die products, and many more that are waiting to get in. The estimated size of the market, and these again are just estimates, based on premium in 1989 was $150 million, with face amount of roughly $10 billion. The average face amount on second-to-die issues is roughly $1.3 million. The number of policies sold is estimated at about 7,500, and if you work it out, it comes out to about a $20,000 average premium. It doesn't really take that many of these policies to generate significant premium volumes. We also anticipate that 1990 will prove to be an even more successful year for second-to-die business, and we also expect that the market will be increasingly competitive as more companies enter the business.

What are the competitive factors in the second-to-die market? Premium flexibility is quite important, either using a UL-type approach, or through the use of paid-up additions and term insurance combinations. Another important factor is the rate of return on the second death. This is even more important than the rate of return upon lapse. These policies are generally purchased to meet a specific estate planning need upon the second death, rather than a specific cash accumulation need.

Realizing a low net outlay is also a goal. Although you might think that this would lead to widespread use of term insurance for second-to-die products, that hasn't happened. Generally since one wants to pay off the policy as quickly as possible, term insurance really isn't a viable option. However, one does want to pay off the policy as quickly and with as low a premium as possible, so the vanish year becomes an important consideration in comparing plans.

Another important element is the treatment of substandard lives. This is important since you're usually selling to an older clientele in the second-to-die business. Many companies have gone to an age rating approach rather than an extra premium approach for simplicity and because they think it's psychologically more advantageous to rate up in age than to charge a large extra premium.

Let's look at a few product design trends on second-to-die business. Universal life is becoming a more common vehicle to fund second-to-die products, but participating whole life and excess interest whole life still are the most common.

Another design feature that is quite common in second-to-die products is the use of paid-up additions and term insurance combinations. Chart 5 is a graphic illustration of how this might work. At the outset, an insured would select a combination of whole life coverage and term insurance. As time passes, paid-up additions would be purchased and would begin to replace the term coverage. Obviously, the more term insurance purchased at issue, the slower cash values grow. Some companies put a limit on the amount of the total death benefit that can be financed through term coverage. The reason one wants the term insurance to vanish is that the cost of the term coverage becomes prohibitively expensive if it were financed all the way to maturity. The idea is to use paid-up additions to get rid of the term coverage. A limit may be placed on the amount of initial term coverage so that one can vanish the term coverage within a reasonable time. Use of term and paid up additions is a very common way of structuring the second-to-die plan.

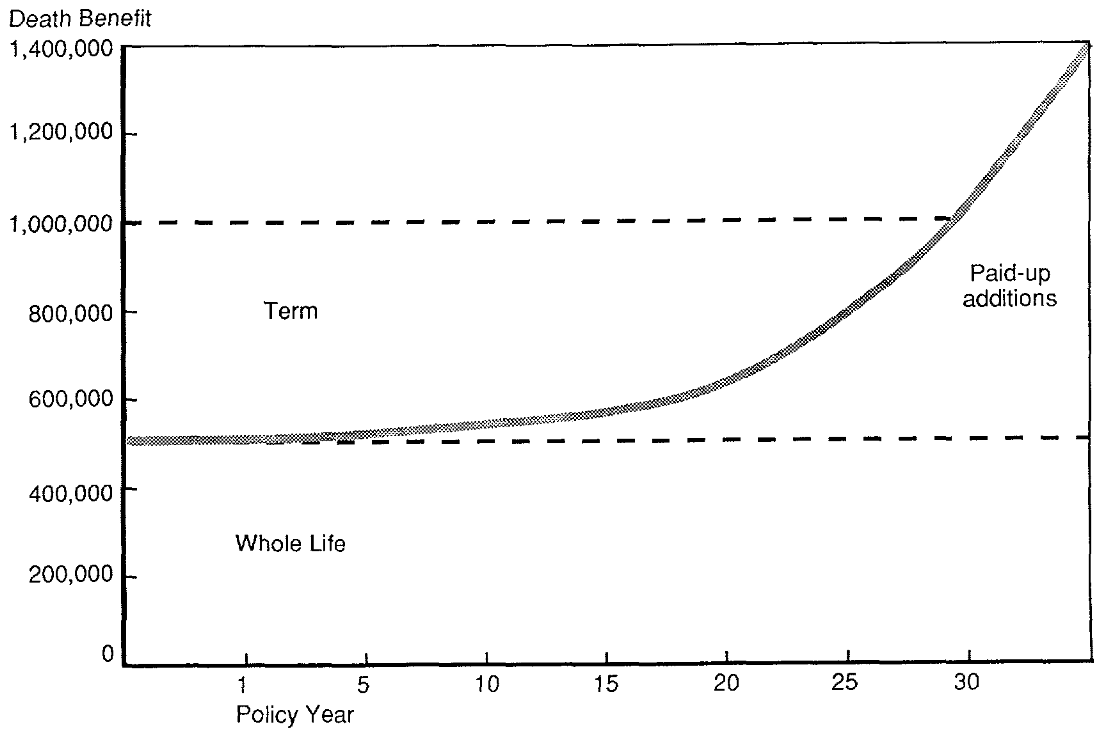
Another key factor in product design is what happens to the policy upon the first death. This is the Method 1 versus Method 2 distinction that many of you are familiar with. Under Method 1, which was initially the most common approach, there would be an increase in cash values, dividends, and term charges upon the first death. Method 2, or the "Frasierized" approach, defined no change upon the first death, and would have smooth values throughout. Originally, Method 1 was used for marketing reasons, because there was some salability in having a "good thing" happen upon the first death, even though strict actuarial theory probably says that Method 2 is more appropriate.

Another issue is the joint equal age versus the exact age approach. The joint equal age approach is obviously simpler, and is the most common way companies structure their second-to-die plans. The exact age approach can lead to a massive effort of defining separate factors for each individual age combination. The problem is that there are a number of states that require that cash values on a joint equal age basis be at least as big as exact age cash values, or at least within a certain tolerance. A number of states will actually question your approach to deriving the joint equal age. In the course of doing these cash value comparisons, a company is forced to do dual calculations. There is some discussion and some negotiation going on now with at least the State of Texas and perhaps a few other states in trying to work out some agreement on handling of joint equal age plan approvals.

Finally, let's talk about riders on second-to-die plans. These have become more common, specifically the policy split option (PSO), which allows insureds to split the contract into two individual contracts upon a divorce, tax law change or other events. It usually involves a point-in-scale changeover. The cost of the rider, at least in one recent study, was determined to be 2-5% of the base policy premium. In most cases, the price actually charged is zero or very nominal -- except perhaps for a company charging an administrative fee for the expense of initiating the split (e.g., $200). There's usually no new commission paid to the agent when the contracts are split.

CHART 5

SAMPLE SECOND-TO-DIE PLAN STRUCTURE



Another rider is the first death rider which, when added to a second-to-die product, pays a death benefit upon the first death to cover burial expenses or any other expenses associated with the first death.

In the business market, some companies have designed change-of-insured riders that allow the policyholder to change insureds in case of a realignment of company management, for example.

Accidental death benefit (ADB) and waiver of premium (WP) are not as important on second-to-die business. Specifically, the waiver of premium benefit is less important because premiums for the contract are not being paid out of current income generally. That's especially true in the estate planning market.

Pricing second-to-die plans is made more difficult because of the lack of insured mortality data, and also because of the guess work involved in realizing that the mortality experience of two lives is not always independent. There's a certain heartbreak factor that must be considered when you have a husband and wife team, or that simultaneous deaths can occur in auto accidents, and it's somewhat difficult to quantify these. There's very little in the way of lapse experience right now, although I think most actuaries believe that the lapse experience on these products should be very favorable. The deferred death benefit, low lapse rates typically assumed in pricing, and the low expenses that would be assumed on a per unit basis result in rates that are pretty attractive when compared to two single life policies.

Just a couple of final issues on second-to-die. The reinsurance market is obviously an important consideration when you start talking about average face amounts of $1.3 million. Most of the reinsurance available on these plans is YRT, although there is some coinsurance of the cost of insurance charges on the universal life varieties. It's safe to say, though, that there are a number of reinsurers that still aren't comfortable with the concept of second-to-die, mainly because of the large face amounts involved. However, it's an evolving market, and as time goes on, reinsurers' comfort levels will go up.

Finally, I wanted to mention the beneficiary purchase option briefly because this rider has been used as an alternative to stand alone second-to-die contracts. The beneficiary purchase option is essentially a form of guaranteed insurability option that is attached to each of two individual policies. Usually the way it's structured is that upon the first death, the owner of the second policy has the option to buy additional coverage on a designated life of up to X times the coverage on the base policy (e.g., X = 5). That designated life is usually a spouse or business partner. This rider approach has advantages and disadvantages when compared to the stand alone contracts. Advantages include the flexibility to determine how much coverage you would like to purchase when the option is available. In many cases, it's simpler to file rider forms, and to get the systems worked out than it is with the stand alone contract. Some of the disadvantages would be the reinsurance problems that you might have with reinsurers that are even more uncomfortable with the rider approach, the claim that the rider is more expensive than the second-to-die policy approach, and also the fear of increased antiselection when an individual has the opportunity to exercise the option.

LIFE PRODUCT DEVELOPMENT UPDATE

MR. MARK A. TULLIS: I'm going to be speaking on variable life and universal life. Overall, my impression is there's not a lot of current product activity for either product. Instead of giving an overview of a lot of topics, I will hone in on one or two product features and trends for each product type, rather than give you a survey.

First off, if we take variable life (Chart 6), and if we extrapolate this chart through about 1991, we can eliminate this product from the discussion, and you can go to lunch earlier. The lined bar represents single life premiums and the black bar, annual life premiums. Obviously, the drop in the single life premium in 1988 was due to the tax law changes which John will discuss later, and what I find surprising is the drop in the annual premiums in 1989. I don't really have an explanation for that, other than maybe some of it was due to the market crash. Elaborating on my earlier point that not a lot is going on, part of the reason that not a lot is going on from the design point of view is there's not a lot of sales.

Just to zip through what you're allowed to do on a variable product, you have a maximum sales load of 9% average, and of course you can heap it up in the first year up to 50% if you refund some of it on early lapse, and 30% if you don't refund some on early lapse. You can go now to 1980 CSO on mortality and a multiple of 1980 CSO if you limit your underwriting. Your expense charges are supposed to be reasonable and somehow related to what you actually expect to incur for expenses. You're allowed a mortality and expense (M&E) risk charge of 90 basis points spread, 60 for a fixed premium product.

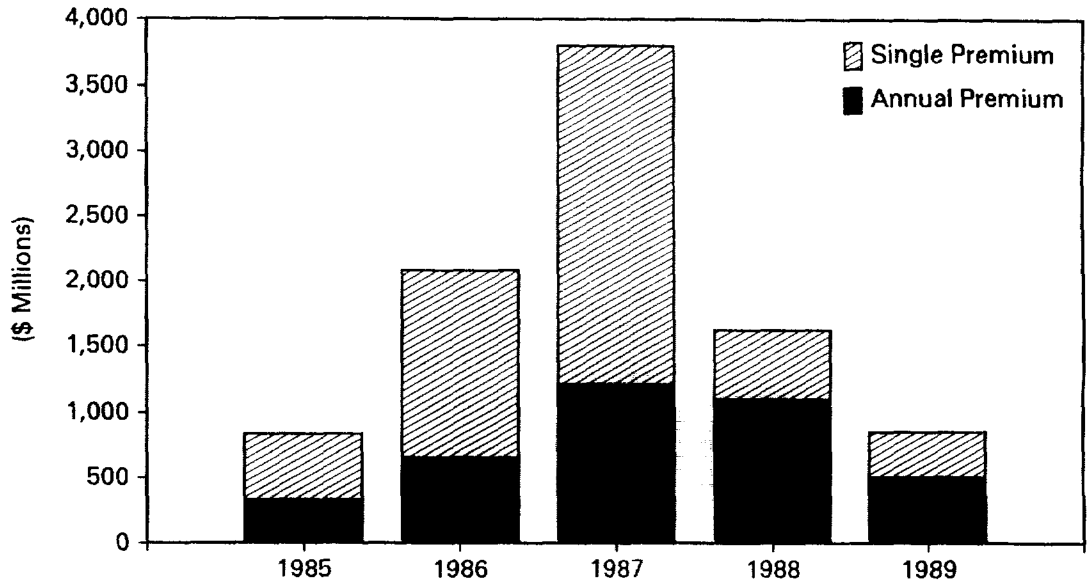
As far as trends we see in the variable area, it's primarily to move the variable design closer to a more traditional, universal life type design first in order to get commission levels up so that they're closer to a traditional UL-type design. Then through lower front-end loads, the trend is to move more of the contract charges out of the front-end and into back-end load, like on the UL design. So, although we have sales loads limited at 30% of first-year premium, companies have been taking other loads like underwriting and issue loads and even in a few cases, premium tax (although that's still generally assessed as a front-end load), and instead of assessing these nonsales-oriented loads on the front-end, they've been converting them to rear-end loads in order to get the rear-end loads a little higher and more like a regular UL. We do a survey of variable products, and two or three of the latest products which have been introduced have no front-end loads except for premium tax. So we see that as a definite trend.

The higher M&E charges have been a trend for a number of years. A trend among some of the more recent products is having unleveled M&E risk charges. Of two of the recent products introduced, one has an 85 basis point M&E charge for years 1 through 20, and then it drops off to 60. Another contract has a 75 basis point M&R risk charge for the first 10 years, and then it drops off to 25. What companies are doing is getting rid of explicit front-end loads, moving more toward the back-end, higher paying commissions, and stacking up the M&E risk charges in the front-end because that's a hidden front-end load and tends not to be quite as noticeable.

The UL picture is considerably brighter than variable, but nevertheless, after the early start in the first part of the 1980s, UL premiums as a percent of total market share in

CHART 6

Variable Life Sales Results



the U.S. appeared to have leveled off at around 27% of the market from a high of 38% in 1985 (Chart 7). I think this ties in with Tim's earlier point that a lot of companies have gone back to their participating products, particularly companies that had been selling participating in the past. A lot of their market share has switched back over to participating business in the past few years. One thing to note, these figures don't include excess interest whole life. This is only flexible premium UL. Perhaps the results would look a little different if you threw in the EIWL, but I think the total picture would be the same; we had a peak in the mid-1980s, and things have trailed off a bit and stabilized. In the mid-1980s everybody wanted to get on the UL bandwagon. I think the market has settled down more to a situation where companies tend to sell things that they feel comfortable with, and that their field forces feel comfortable with, resulting in more stratification by companies by the type of product that's being sold.

There's a couple of UL design-related issues that I'm going to hit on. As far as what's being sold, I will first discuss product and policy enhancements. There's a session on this later, so you can get as much detail as you want, but basically, policy enhancements are changes in product features so that the deal for the policyholder becomes better with time. An example would be an illustration where the illustrated interest rate increases after a certain year. The agent then sits down and types out that he wants an 8% illustration, but what he gets is one that goes 8% for 10 years, and then 9% thereafter. Another example would be if you have cost of insurance rates where the company charges more in the early years than in some of the later years, so you have kind of a reverse, select and ultimate design.

Companies have used enhancements for a number of years, and they've become quite popular, and it's primarily to help out illustrations of later-year values. Essentially, what you do is penalize people early on and reward people later. I break enhancements down into two types. First, prospective enhancements are shown in Chart 8. What I've attempted to chart here are cash values where the dotted line product is a vanilla product, and the solid line product is one with enhancements, and the two products make about the same profit margin. If they make the same profit margin and the enhancement produces better values later, it's got to produce junkier values earlier, otherwise the profit margin won't be the same. The thing to notice about the prospective enhancements is that the line is nice and continuous and there's no jump or anything like that. Examples of prospective enhancements are stepped credited rates where the credited rate might increase with time, or where when you get to a certain cash value, the credited rate may pop up. Other examples are reverse select and ultimate cost of insurance rates, or where an expense load may go down at some particular point in time like the variables examples, where the M&E risk charge went down at a certain point in time.

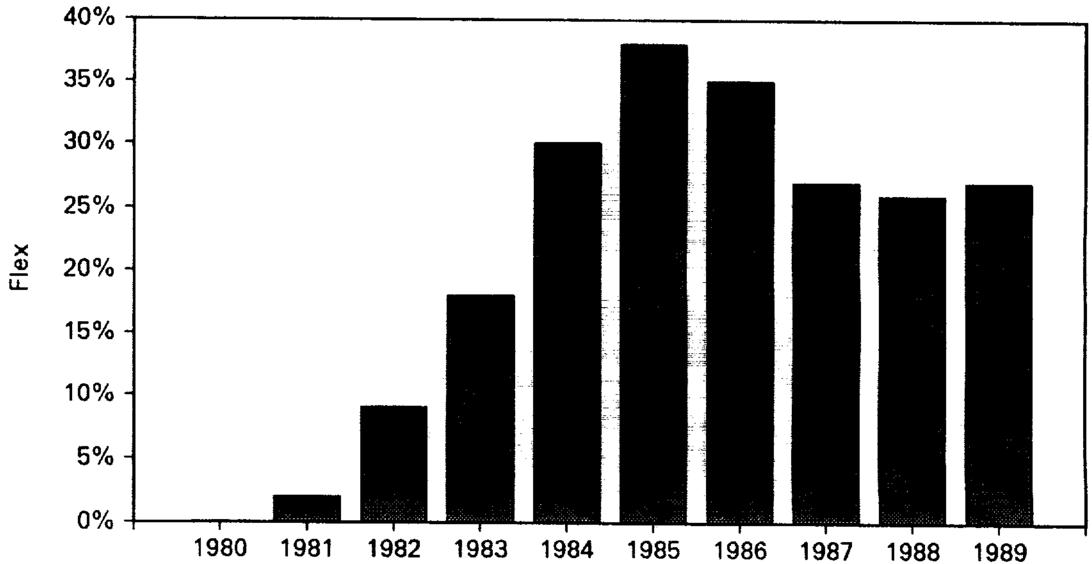
The most powerful type of enhancements are retrospective enhancements (Chart 9), and these are deals where you not only make things better for the future for the policyholders, but you somehow give them credit for something that went on in the past.

The example I like to make in comparing retrospective and prospective is, say you've got a job where you have to fly around a lot and you prefer to fly United, but your boss makes you fly Eastern Airlines all the time. So you rack up all these frequent flyer

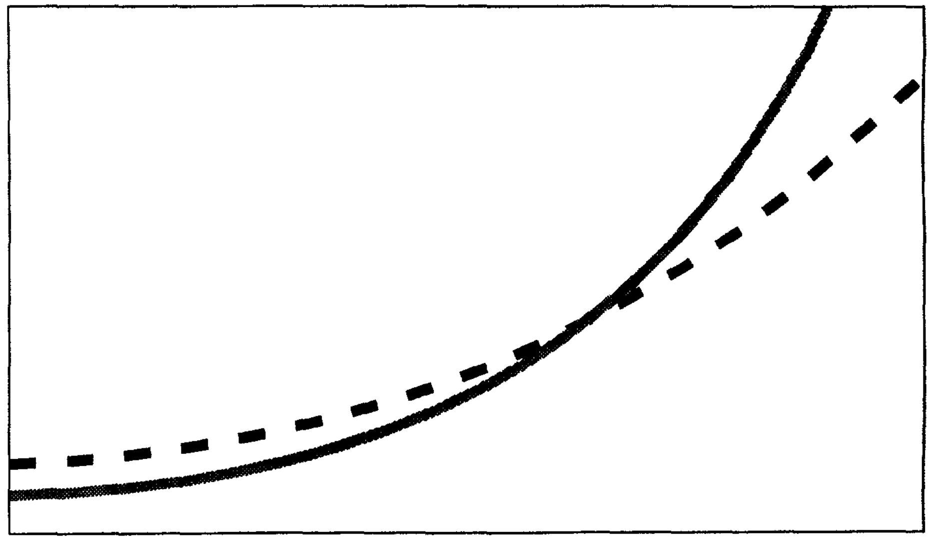
CHART 7

Universal Life Sales

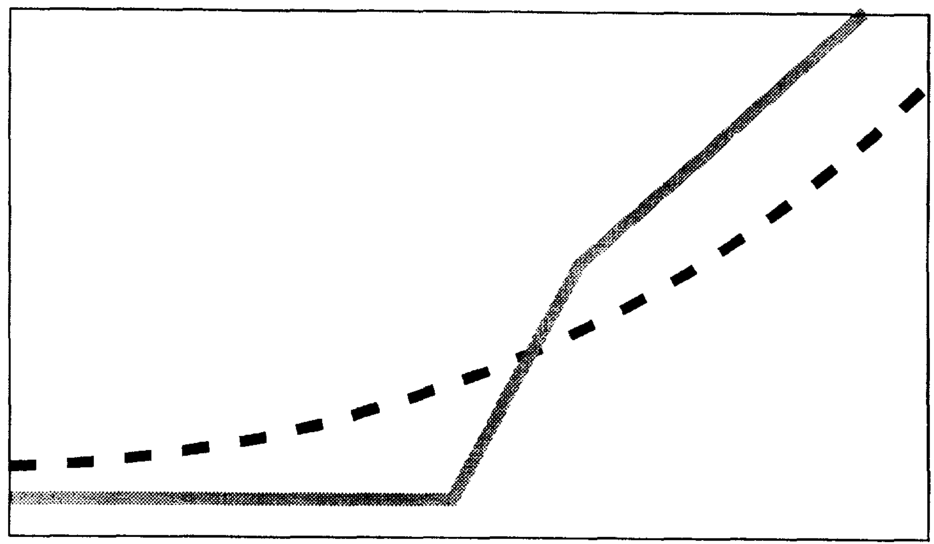
Percent of Total Annualized Premiums



Prospective Enhancement



Retrospective Enhancement



credits, but they're on Eastern. Prospective enhancement would be where your boss comes in one day and says, "Well, I've got good news for you. We've worked out a deal with United, and you're going to get to fly United from now on." So from that day forward, you can rack up United miles, and so that's a prospective enhancement.

Retrospective enhancement would be where your boss comes in and says, "From now on you can fly United and we've worked out a special deal where we're going to transfer all your frequent flyer credit on Eastern over to United." That's a retrospective enhancement. So you can see why retrospective enhancements are a lot more powerful in some sense and tend to boost up the later year cash values.

Examples of retrospective enhancements are where you get to year 20, and the cash values for the first 19 years are recalculated at a higher interest rate. Also, lump sum distributions, where you either refund some expense loads or perhaps refund cost of insurance rates would be retrospective enhancements. The thing to notice about the retrospective enhancements is that they tend to produce discontinuities.

How predominant are enhancements? Our latest product survey (Chart 10) shows that approximately 33% of the products surveyed had some type of enhancement, but I think, more importantly, the products which tend to perform the best tend to have enhancements. In fact, the top 10% products ranked in that survey all have enhancements. As you can see, I've taken a distribution by product of the type of enhancements, and the top 3 are prospective and the bottom 2 are retrospective. So, most companies have gone with some kind of prospective enhancement, but I think that's a little misleading, because the products that tend to perform the best tend to use the retrospective design.

CHART 10

Distribution by Type of Enhancement

Stepped credited rate by duration	33
Stepped credited rate by amount	10
Tiered credited interest rates	3
Retroactive crediting of interest	6
Lump sum distribution bonus	20
Total	72

My feeling is that companies are moving away from the use of enhancements, and maybe there's even a backlash against them at the field force level to some degree. I've heard stories about companies that have been pioneers in the use of enhancements and have decided to scale back somewhat and redesign some products without enhancements, or at least attempt to minimize the enhancements. I think a lot of that is because there's been some policyholder misunderstanding about whether values are really guaranteed or what discretion there is at the company level, and there's been a lot of criticism within the industry about the use of enhancements. This is going beyond what I was supposed to talk about, but I never hesitate to put in an editorial comment: Personally, I can see pros and cons about enhancements, but I don't feel that enhancements themselves are good or bad. To me, the problem is that if companies tend to do illustrations that are nonsupportable, then I don't see a difference between coming out with some enhancement where you have very little hope of actually fulfilling the promise than coming out with a dividend interest rate that you don't really expect to credit.

So I don't really see that enhancements in and of themselves are a problem. I see that the real problem tends to be whether or not a particular company or companies in general are really in a position to support what they illustrate.

On the next topic, look at what's happened to statutory and tax reserve interest rates over the past few years (Chart 11). Of course, the two were coupled in the early 1980s, and then were decoupled in 1986. Since 1986, statutory interest rates for a whole life type product or ULs have actually declined a little bit, whereas the tax rates have zoomed way up. So you've got a situation where the rate that you're required to use on tax reserves now is a whole lot higher than the maximum rate that you're allowed to use on statutory reserves. This has led to a couple of interesting points. One is we're in a position now where all profit testing should be done on an aftertax basis, not that it shouldn't have been done on an aftertax basis in the early 1980s, but now it makes absolutely no sense to look at pretax margins and not look at aftertax margins.

Second, I think there is the beginning of a product trend towards higher cash value designs both with UL and non-UL products.

I've looked at a test UL product with statutory reserves calculated at 5.50%, and tax reserves at 8.37%. The product has surrender charges that are high, but not ridiculously high, and surrender charges that stay level for 15 years, and then grade to zero in year 20. This is a vanilla UL. There are no bonuses or anything to confuse the results.

We run it through the computer, and the results spew out (Chart 12), and we get an aftertax margin of 5.9%, an effective tax rate of close to 50%, and ROI with target surplus of 17.8%. People think about what the tax rate for life products is, and they tend to think in terms of 34%. But the difference in the statutory and tax reserves works mathematically like a deficiency reserve or excess target surplus to some extent. So even if you price without target surplus, you end up with tax rates greater than 34%, because you don't get full deductibility of your statutory reserves. You can see that in Chart 11 with the really high effective tax rate.

Now to make the point, we've kept everything exactly the same -- all the assumptions, the product, everything -- except that, instead of keeping the surrender charge constant through year 15 and then grading it to zero in 20, we kept it constant through year 10 and then graded it to zero. So this is exactly like the previous product, except that the cash values are greater than or equal to what they were previously. And the interesting result is that, although the pretax profit went down, which makes sense because you're paying out more surrender costs, the aftertax profit remained virtually the same, and in fact, the ROI actually increased. We have a situation where, by making no other change except increasing the cash values, you've actually increased the profitability on an aftertax basis, which is really all that matters. This is a case where the first company could actually pay out extra to the policyholder, and make more money. We've noticed

CHART 11

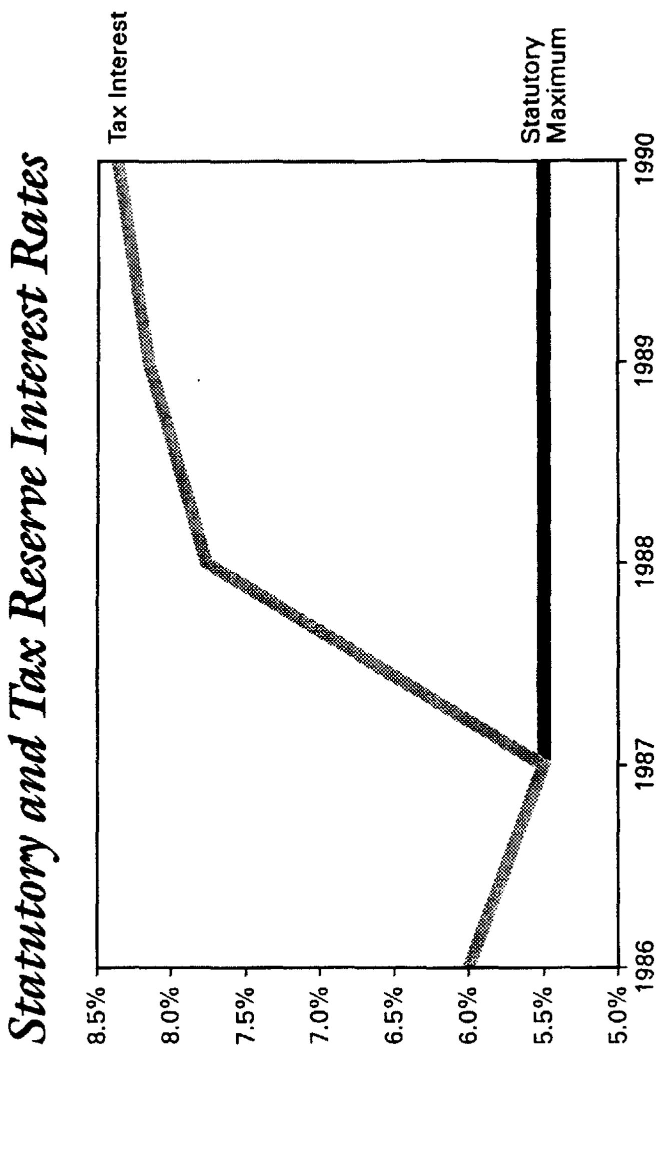

Statutory and Tax Reserve Interest Rates
Tax Interest
Statutory
Maximum
8.5%
8.0%
7.5%
7.0%
6.5%
6.0%
5.5%
5.0%
1986
1987
1988
1989
1990

CHART 12

Test Product

Profit margin	
Before tax	11.7%
After tax	5.9
Effective tax rate	49.6
ROI with target surplus	17.8

in some recent product design work that companies have started looking at this, and we expect a reversal of the trend of a few years ago to maximize surrender charges.

On Chart 13, the cash values are the lined bars, the black bars are the statutory reserves, and the white bars are the tax reserves. The interesting thing is, since the tax reserves are at least equal to the cash value, when you get out to year six, and the cash value starts pushing the tax reserve up. So there's this 8.37% and this formula you go through to calculate your tax reserves, but in fact, at some duration, the tax reserve actually becomes purely a function of the surrender charge. So by modifying the surrender charge in the later years, you not only effect the surrender amount paid out on surrender to the policyholders, but you also affect the tax reserve for the contract. What happens, particularly if you get beyond year five or six when you get past the heavy early lapses, is that you get to a point where increasing the tax reserve actually has more of a positive effect on the company than the extra surrender value paid out.

This example was done with a UL contract because I was supposed to talk about UL, but it doesn't just apply to UL. We found the same thing to be true with some participating products that we've tested as well, and of course, the EIWL products which tend to have pretty big surrender charges.

So the last point to leave you with is that you might want to look at whether you are in a situation for some of your products where you can actually increase the profitability through increasing the cash values.

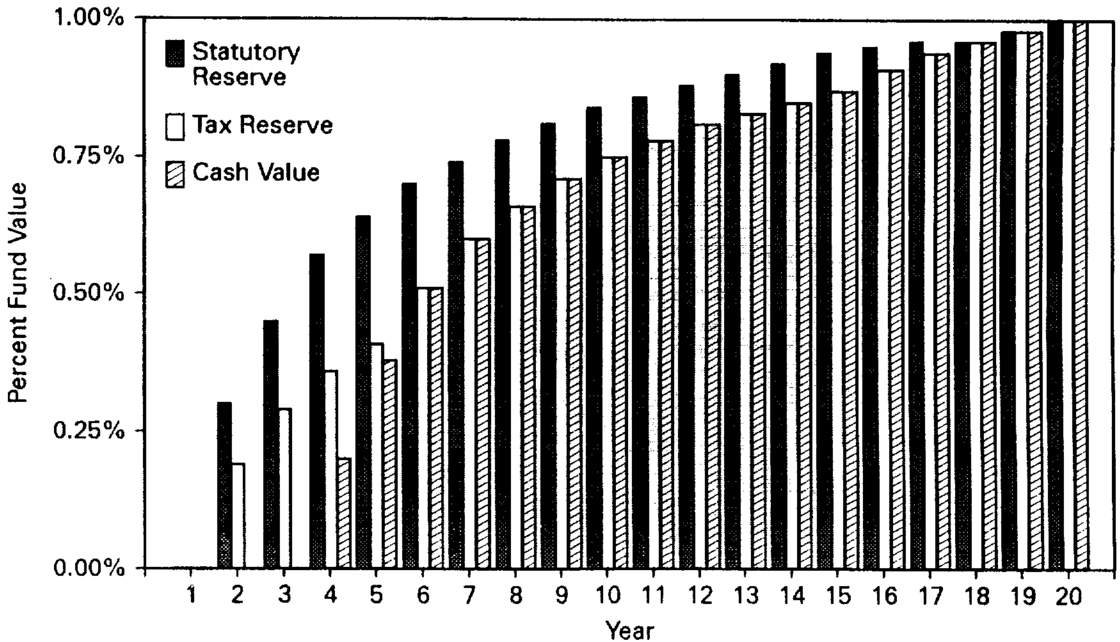
MR. JOHN T. ADNEY: I've been given the task of focusing on single premium and other investment-oriented life insurance products and their federal income tax treatment. And I suppose that's fitting, since we're nearing the second anniversary of the effective date of the modified endowment rules. I'm not sure that is cause for celebration, but at least it is a fact we can't get around. In this discussion, I will assume, when we talk about investment-oriented life insurance products, that we're talking about products that would be defined as modified endowment contracts or MECs under Section 7702A, or products that are operating right on the edge of the modified endowment rules -- those which are trying to stay out of the rules but just barely.

As you know, in the 1988 tax law which enacted the modified endowment rules, Congress mandated the Treasury Department and the General Accounting Office (GAO) to file reports with Congress concerning the taxation of these products, the investment-oriented ones among others.

The General Accounting Office reported in on time and the Treasury Department nearly did so: in January 1990 Congress received a report from the GAO, and in March from the Treasury Department, stating their respective views on the taxation of insurance and annuity products in general, and the investment-oriented products in particular. The intent of Congress, I think, was to see how well the 1988 tax rules were working in light of the congressional purposes in enacting them, which were multiple. Not surprisingly, when both of these agencies studied the markets (to the extent they could find good data), they reported to Congress an enormous drop-off in the sales of single premium life insurance policies after 1987.

CHART 13

Cash Value as Percent of Fund Value



I think the statistics they cited were interesting, and I want to share them with you. However, I want to put a caveat on the record here -- I am a lawyer citing statistics to actuaries. That's very much like one of you bringing complex, multiparty litigation in federal court grounded in diversity jurisdiction. There's some probability you could do it very well, but that probability is low. The probability that I will handle these statistics, and interpret them, in the proper fashion is also low. But, nonetheless, I can take some comfort out of the fact that I am repeating what the government agencies said.

The General Accounting Office apparently looked at LIMRA data on this subject. It found that, as far as sales of single premium policies were concerned (measured by premium volume), in 1987 the premium volume had been at a record high of $9.4 billion -- about a 90% increase over 1986 sales -- but then in 1988 sales went down to $4.8 billion, a 50% drop from 1987. And the GAO also noted that preliminary LIMRA data for 1989, available to the GAO in January 1990, showed a further drop-off from 1988: sales through September 1989 were only 30% of amounts for the first nine months of 1988. That was indeed a spectacular drop. The GAO speculated in its report to Congress that "for the present," as it said, this was due to the 1988 legislation. I think the caveat "for the present" meant that the General Accounting Office was not entirely sure that sales of the single premium or investment oriented products would remain depressed. In fact, it said to Congress, "Several new products have appeared that comply with the 1988 act, but may not be in the spirit of that act." (We'll have more on this later as we talk about what those products are.)

The Treasury Department looked at both LIMRA data and ACLI data, also for a variety of years ending in 1988. In 1987, according to ACLI data, single premium sales were at about $15.6 billion, and in 1988 dropped to $11.8 billion. The ACLI data included paid-up additions, so I'm not sure to what degree the data are showing the right numbers, but they seemed to be following at about the same trend as the LIMRA data. The Treasury also cited LIMRA premium, for single premium policies, as being $8.4 billion in 1987, about a 33% increase over 1986, and then dropping to $5.2 billion in 1988, about a 40% drop from 1987.

It is unclear why the GAO and Treasury data from LIMRA differ by about a billion dollars a year, but I suppose that was "close enough for the government," and the point is that the agencies found a large drop-off in single premium policy sales. We all expected that this would exist, and indeed I suspect that it was the threat of the 1988 legislation, more than the legislation itself, that caused the drop-off in sales from 1987. The 1988 legislation, once its details became known, may have stabilized the single premium market to some degree. The Treasury, by the way, specifically cited a December 1988 LIMRA report showing about a 45-50% decrease in single premium business in 1988, and like the GAO, the Treasury noted that the LIMRA report for 1989 was showing declining single premium sales on into 1989 -- that the first nine months of 1989 had sales of only about 27% of the first nine months of 1987.

So we can infer from these data that the 1988 law had a discouraging effect on investment-oriented product sales, at least through September 1989. I will have more on the subsequent period in a bit, but I'll stop here to note that, while the agencies found this depressing effect on the market, this did not stop either agency from recommending to Congress that the tax rules be changed again. The General Accounting Office, as I think you know, recommended to Congress that something like the 1987 Stark-Gradison bill, applying the "annuity rules" to all lifetime distributions from life insurance contracts, be enacted. In other words, I think the GAO would like to have Section 7702A repealed. That, alone, might get a lot of support in this group, but the GAO would also like to apply the annuity rules to lifetime distributions from life policies, which will only get a mixed reaction, at best, from inside the industry. The GAO said to Congress that it would be perfectly all right in tax policy to tax inside build-up, but it went out of its way to note that it was not recommending a tax. The author of that portion of the report, I believe, was Dr. Nat Gandhi of the GAO. Nat comes from India, and he says he knows a sacred cow when he sees one.

The Treasury Department, which had historically recommended inside build-up taxation, did not do so this year. In fact, the Assistant Secretary for Tax Policy, Ken Gideon, recently has told several industry audiences that taxation of inside build-up was no longer an objective of the Treasury Department. I think it's fair to say from his remarks, however, that narrowing what will be considered inside build-up, free of current taxation, is still a priority at the Treasury Department. We will simply see more "indirect attacks." The Treasury listed several in its report. It suggested that something like the annuity distribution treatment be applied to all life insurance contracts during their first 7 years. (I'm not sure what the effect of that would be, but it seems to me that for many non-MEC contracts the build-up it is what's available in the first seven years is not that great.) They also criticized the current treatment of single premium deferred annuities and other deferred annuities, and said that inside build-up there ought to be taxed unless the contracts dedicate themselves to some form of life annuitization. I suspect we'll be hearing more about that subsequently, and that could very well produce a big battle in Congress between the Treasury and the industry in a subsequent year. As you also know, the Treasury Department recommended that the interest deduction for interest paid on policy loans under corporate-owned life insurance be abolished. That was not unexpected, and we will talk a bit more about that.

Such were the conclusions and recommendations of the Treasury and the GAO, and they had little or nothing to do with investment-oriented life insurance except, perhaps, that I believe that there was some concern with the single premium and the other investment-oriented markets that was leading both agencies to their conclusions. I think that both agencies felt that applying the MEC treatment to all life insurance contracts during the first 7 years, or even permanently, may be necessary because of doubt about the effectiveness of the MEC rules, definitionally, or for that matter the definition of life insurance itself.

Is this concern justified, or is the single premium market now so limited that we should simply disregard it? In pondering this, we note another LIMRA report, which was published after the agencies' reports were published, and was discussed by Khan Zahid (a LIMRA analyst) in the May 1990 issue of *Best's Review*. Mr. Zahid observed that, while single premium sales in the first nine months of 1989 had declined to only around 25% of what they were in the first nine months of 1988 (1988 itself was a bad year, so that was a major decline), in the fourth quarter of 1989 single premium policy sales actually increased. According to the report, they went up to about 5% of their fourth quarter 1988 level. That is not a stellar level by any means, but it is quite interesting that they did go back up to some degree. We obviously have no statistics on how well the single premium sales are doing thus far in 1990.

Is this pick-up indicative of a new trend, or new products, or something else? Those are interesting questions, and I don't have any very good answers. For that matter, I really wonder whether these figures reflect, in any way, the market for nonsingle premium, investment-oriented products. What other sorts of investment-oriented products, in other words, are out there that are not single premium and are not being reported? That may be the main question here. I have in mind, for example, the multipremium policy that is purchased in combination with an immediate annuity. A single deposit is made, and the premium is divided into the first of 7, 8, or 9 life insurance policy premiums, with balance goes into an immediate annuity which will then have the task of paying out the additional premiums remaining on the life insurance policy. This certainly is not quite as efficient an arrangement, from a tax perspective or any other perspective, as the old single premium life insurance policy before the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), but nonetheless it is a single premium kind of sale. I will call it "quasi-single premium," and I think some focus on the quasi-single premium market is worthwhile in this discussion.

In 1989, for example, the second-to-die policies with dropping face amounts were sold as nonmodified endowment contracts. These products were sold essentially with a single premium, but in form they were annual premium products. I doubt that they were reflected in any of the single premium sales statistics, yet they clearly are investment-oriented products worth noting. As you know, legislation in 1989, the so-called Kennelly Amendment (Section 7702A(c)(6)), stopped the sale of those products as nonmodified endowments by legislating that once the face amount of the policies dropped, there would be a retroactive retesting under the 7-pay test of Section 7702A. These were, in any event, multipremium products sold with a single payment, and did not get reported in the single premium sales statistics.

I gather, then, that in 1988 and 1989 tax legislation substantially dampened the single premium market. Perhaps it has discouraged sellers of the product away from life insurance products and into other financial instruments.

But aside from efforts to quantify this market, we might as well ask what kinds of products are being sold, particularly in the quasi-single premium market. For this, the sales data that we have have some, but very limited, use. Perhaps more indicative of what is being sold are the questions that one hears about the tax treatment of the single premium and quasi-single premium products. The tax treatment -- the qualification of the products under the definition of life insurance, or avoidance of modified endowment contract treatment -- is still very important in these markets. I would like to share with you the kinds of questions that I have been hearing, and the frequency of those questions, as a way of indicating what is happening in the investment-oriented product market.

First, with regard to new-money sales of single premium policies, as you would expect there have been far fewer questions about the treatment of those products than in prior years, but, interestingly enough, there are still some questions. Questions come in regarding compliance with the definition of life insurance: that is still very important, especially to the distributors of the products. There are also questions, obviously, about the treatment, disclosure and reporting of distributions from these products under the modified endowment contract rules.

Under the definition of life insurance, questions come up about what mortality and expense charges may be assumed in computing guideline premiums. For example, what is to be done with substandard cases, and, in particular, what is to be done with simplified issue cases? Is it possible to charge, or assume, a mortality charge in excess of 100% of 1980 CSO mortality for simplified issue cases, in calculating a guideline premium or a net single premium under Section 7702? The general answer seems to be that it is probably not safe to do so, for a variety of reasons. We are awaiting, as you know, regulations on the application of the mortality and expense charge limits that were added to the definition of life insurance in 1988. Although Congress mandated regulations by January 1, 1990, we do not yet have them, the Treasury Department has said that, now that the product reports have been issued, it is hopeful that it will be able to act soon upon recommendations it has received from Internal Revenue on regulations for application of the mortality and expense charge limits.

As far as the Section 7702 regulations generally are concerned, the Internal Revenue Service has been working on them. ACLI has been making further submissions to the Service on the subject, but I think the Service is coming to grips with the enormity of the exercise, and is telling people that they're probably not going to see draft regulations until extremely late this year or maybe sometime in 1991.

In one variant of the new-money single premium products we have seen, the single premium policy is sold with a long-term-care rider. I am not sure how many of these are in the market, but I would assume that the rider is added to heighten interest. The long-term-care rider essentially accelerates the death benefit under the single premium policy on some basis whenever an individual is confined to a nursing home or another kind of care facility, and I would further assume that such arrangements could be structured with other forms of accelerated death benefits.

This type of product has led, interestingly enough, not so much to questions about the single premium policy as to questions about the treatment of the benefits under the rider. That is a totally different topic, and suffice it to say for now that, as far as obtaining any tax clarification of the treatment of long-term-care benefits or accelerated death benefits, we are not expecting any further administrative clarification. Congress has been studying the long-term-care problem for some time, and it is expected to continue to do so because there is no consensus in Washington yet as to the handling of this problem generally. However, there is one interesting development to watch for: assuming that a tax bill begins to move once the President and Congress reach an agreement on how much of a tax increase there should be this year, we expect that Congresswoman Kennelly and Senator Bradley will make separate efforts to have the respective tax writing committees add to the tax bill their bills on the treatment of accelerated death benefits in the case of the terminally ill. These bills are designed to deal with, for example, the kind of product Prudential now has on the street, where it has said that, if an insured is terminally ill with some kind of medical certification that the insured is expected not to live more than 12 months, then Prudential will prepay the death benefit under its policy. The bills are aimed at declaring such a death benefit to be a Section 101(a)(1) tax-exempt death benefit. We could very well see something like that being enacted in the tax legislation in 1990.

Beyond new-money, single premium sales, I gather that most of the sales cited in the statistics from the various sources would be "rollover" or replacement sales, where existing policies have their cash values rolled into a single premium policy for a variety of reasons. That could be the absence of continuing need for greater insurance protection available in times past. It could also be the search for a better interest rate. In the case of the rollover sales, we continue to hear many questions still, which is why I think this is an important part of single premium sales today. The questions we hear typically regard maintaining nonmodified endowment status. While a replacement contract issued in a Section 1035 tax-free exchange would technically be subject to 7-pay testing under the modified endowment rules (it is not grandfathered since it was issued after June 20, 1988), the use of the "rollover rules" under Section 7702A itself will keep the non-modified endowment status for the contract if no additional premiums are paid under it for at least 7 years. This was clarified in the legislative history of the 1989 legislation. Frequently people will call in and say, "I understand the contract is still grandfathered." What they mean is that it still has nonmodified endowment contract status, which is correct if it is handled properly under the rollover rules as clarified in 1989.

There is, of course, an exception to this: if the contract being replaced was itself a modified endowment contract, then the new contract will be a modified endowment contract. In view of this, one question that has begun to arise is how companies are to determine whether the replaced contract is or is not a modified endowment contract. I suppose the replacing company can ask the policyholder. Beyond that, it would be necessary to establish some kind of reporting procedure between companies. That will need to be worked on before satisfactory procedures are put into place. It will become more of a problem as time passes because, as yet, there hasn't been much opportunity to create modified endowment contracts, let alone replace them. It will become a major concern, particularly for reporting by the replacing company, once distributions are made, if they are made, under the new contract.

Another question that arises in the context of rollovers is, what is the treatment when several existing contracts are rolled into a single premium policy? What is the treatment, it is asked, under Section 7702A? Maybe the more pertinent question is, what is the treatment under the tax-free exchange rule of Section 1035? We do not know at the moment precisely what the treatment of a combination rollover will be. For many years the industry has simply assumed that if two or three old contracts are exchanged for one new one, this would be a tax-free exchange under Section 1035 so long as no cash changes hands in the course of the exchange. I think that's pretty sound under the statute. However, you should know that private letter rulings issued in connection with rollovers of business from Baldwin United to the Metropolitan and others, in connection with the Baldwin rehabilitation, stated that Section 1035 contemplated the exchange of one policy for one other policy. If that is correct, then exchanges of two policies for one, or one policy for two, would not be Section 1035 exchanges.

Another investment oriented product about which we hear questions is the so-called paid-up additions rider on a whole-life type of plan. These riders may or may not be used in an investment-oriented setting, but I will focus on the ones that are. The concern here is one of avoiding violation of the Section 7702A 7-pay test. This will require monitoring, initially and continually, under the product. In particular, the need is to avoid "material change" treatment, which will beget the application of the rollover rule, which will beget the inability to pay premiums in future years. The 1989 legislative history under Section 7702A was helpful in this regard, by clarifying that the "necessary premium" exception to the material change rule could be applied in a beneficial way in this circumstance, that is, the mere existence of an increase in a death benefit need not necessarily be considered a material change. The increase would only be a material change after the premiums paid cumulatively had exceeded the necessary premium under the contract prior to its change, as defined in the 1988 legislative history.

While this is helpful to the paid-up additions rider product, there still is need for constant monitoring of 7-pay compliance, and in this regard ACLI has also been busy, not only for this product but also under Section 7702A generally, in trying to frame a consistent statement on what constitutes a material change. My understanding is that a paper being developed on this subject will eventually be published as an ACLI general bulletin, providing guidance on this subject. I also understand that ACLI is considering seeking several technical corrections to Section 7702A to deal with such situations as off-anniversary material changes, corrections of errors, and the treatment of benefit reductions when a qualified additional benefit under a contract is paid.

The fourth and final category of products I would consider investment-oriented products are the quasi-single premium policies -- for example, the 7-pay or 8-pay or 9-pay policy that is sold with an immediate annuity. The central question that arises is whether the premium that is supporting the immediate annuity will be considered a premium under the life insurance contract when it is received by the company. The answer is it better not be, or otherwise this plan doesn't avoid modified endowment status as intended. I think it's fair to say that, so long as there is no subsidization of charges between the annuity and the life insurance policy, so that each of the two products is indeed free-standing, separate, and actuarially independent, then in all probability the modified endowment rules will be interpreted as not covering the payment for the immediate annuity. As a result, this kind of product will indeed not be considered a modified endowment even though, from the policyholder's perspective, only one premium has been paid. I suspect this is the kind of product that the General Accounting Office was referring to when it talked about items that may have been within the letter, but perhaps not the spirit, of the 7-pay legislation.

Interestingly though, I think if you talked with Congressional staff members about this, they would not be too concerned. Those that believed in the lines drawn by the 7-pay test would say that this is precisely the kind of product that should not be a modified endowment. I think others would tell you that they don't particularly care for that debate because they don't believe in the 7-pay test anyway, and all life insurance policy distributions ought to be taxed under the annuity rules. So, I doubt that criticism will particularly be directed against this product. However, if and when Congress again looks seriously at something like a GAO or Treasury proposal to change the tax rules, you may very well see the quasi-single pay plans being cited as a reason to change the law.

The second-to-die plans that were discussed earlier are also, or can be, used in the quasi-single premium setting. These are not the multipremium sales intended to benefit the estate. These are sales that are largely made with one premium payment. This was the case with the dropping face amount product sold in 1989, that was largely terminated by the 1989 legislation. Under the 1989 legislation, the second-to-die contract that is paid for with a single payment but in form is a multipremium policy is not a modified endowment contract unless and until there is a drop in the face amount. Under new plans that I understand will be appearing in the market, the objective will be to push back, as far as possible into the future, the date on which the benefit needs to drop in order to make the arrangement economically viable. This is done by looking for ways to keep the cost of insurance charges down while both insureds remain alive. I think you will see this type of product on the market, since there will be interest in it from an investment-oriented standpoint. It could very well be, again, a plan that would be cited to Congress as a reason to change the law in the future.

This list of investment-oriented products being sold or soon to be sold is not exhaustive. Overall, I would conclude, as I think you would, that the single premium market is substantially contracted, but certainly not dead, especially in view of the sales of quasi-single pay products. Rollovers, again, probably account for most of the true single premium sales.

Where does this lead us in the future? I think that will largely depend upon what Congress does to the tax treatment of the products, and for that matter, to the tax treatment of the nonmodified endowment life insurance products and to other financial instruments, such as annuities. We do not know what Congress will do, but we suspect that it will look at these products again. The Treasury and the GAO have recommended changes, and those will be dealt with in due course.

I doubt that we are looking at serious congressional action on insurance products in 1990. I suspect that Congress is rather tired of hearing about this subject and will shy away from acting on it, with the possible exception of limited action on accelerated death benefits and action on a bill to circumscribe interest deductions on policy loans under corporate-owned life insurance. The latter of these is likely to come up because Congresswoman Kennelly has introduced a bill, at the urging of the National Association of Life Underwriters among others, that she intends to move forward in the Ways and Means Committee. I think this is viewed as a protective strike for the industry against proposals from the Treasury Department to do away with the corporate owned life insurance (COLI) interest deduction altogether. Kennelly's bill would not go that far.

So, I think we will see some action by Congress on COLI, and on accelerated death benefits, and then not on much else until perhaps 1991 or 1992, after the staffs have had an opportunity to assimilate the recommendations of the GAO and the Treasury. At that point, everything will be back on the table, and once again we will be examining the fundamental tax treatment of life insurance products.

PANEL DISCUSSION

FROM THE FLOOR: Did the ACLI write or submit a paper to the government urging that for simplified issue life insurance products, reasonable mortality charges under the statute should include 1980 CET charges?

MR. ADNEY: There is such a paper. It was filed with Internal Revenue, Bill Schreiner, when was it filed with Internal Revenue? A few months ago? And I believe Internal Revenue has looked at it.

MR. WILLIAM J. SCHREINER: We filed it last fall as part of a general submission with respect to substandard mortality charges suggesting that 1980 CET might be appropriate for the guaranteed issue when using simplified issue products. I must say though that the Treasury really was not enthusiastic about this suggestion. It already thinks there's margin in the 1980 CSO, and it's going to be a tough job really convincing the Tresury that a table with still more margin is needed.

MR. ADNEY: Yes, I certainly agree with Bill's observation. I think it will be very difficult to persuade the government that, in the absence of some underwriting need, you should be allowed to use more than 1980 CSO, and I don't think the government would consider guaranteed issue or simplified issue to be within that. Also, I think it's going to be a difficult job to convince the government to allow any insurer to take any substandard charge into account that the insurer is not prepared to charge on a current basis. I think the government's position probably will be that, to the extent a company goes beyond 1980 CSO in the mortality charge assumption in the guideline calculations, it may do so only to the extent it's actually making the charge. How you conclude that the charge is actually being made is another question, but I think the government is going to take a very hard line on that subject.

MR. TIMOTHY P. SCHILTZ: I had a question for Tim on the last survivor plans. I was wondering what are the underwriting standards of some of the companies with respect to the two lives? Are they underwriting each individual life, or the combination of the two lives? Also, are they underwriting the total face amount, or some portion of that face amount?

MR. PFEIFER: It's my impression that companies are looking at each of the individual lives separately obviously with consideration to the total death benefit that they'd be under, the risk they'd be under. But they are looking more at the individual life separately as opposed to sort of a combined mortality risk.

MR. SCHILTZ: Are they looking at the full face amount or some portion of the total?

MR. PFEIFER: Total face amount is what I believe is the case.

MR. DESROCHERS: I'd like to follow the question up, Tim. How prevalent is underwriting one life as an uninsurable or offering the product to one uninsurable life or a very highly substandard life?

MR. PFEIFER: I think it varies all over the lot by company, but it's not at all uncommon to have one of the insured lives be uninsurable, and as I mentioned in the presentation, I think it's much more common these days to use an age rating to adjust that rather than try to impose some very large substandard premium on the uninsurable type life.

MR. JAMES M. HEDREEN: I have a question for John on the 1035 of pre-TAMRA single premium life. The way I read that, I'd agree with your interpretation except that you didn't mention anything about issuing a new contract based on the surrender value, which is going to be lower. You can often have a death benefit that was lower than the old policy, and I think if the death benefit drops, you have a severe problem and it will become a MEC. Do you agree or disagree with that?

MR. ADNEY: I think whether it becomes a MEC will depend upon the status of the contract that was being replaced and how long it's been around.

MR. HEDREEN: It's been around less than seven years.

MR. ADNEY: Is it a grandfathered contract?

MR. HEDREEN: It's pre-TAMRA.

MR. ADNEY: If it's a pre-TAMRA contact, I think you are free to drop the death benefit when you roll it into the new product. You will probably produce a negative seven-pay limit or you could, but as long as you don't pay additional premiums, I think you'll be alright. The drop in benefit rule is only going to attach formally to the new contract. It never attached to the old one because Section 7702A never applied to that grandfathered contract. That was the thrust of the legislative history clarification in 1989 on the rollover rule as applied to the grandfathered contracts. Now change the facts a little bit, and let's suppose that indeed a contract was issued in 1989, and now we are six years later, and the proposal is to roll that contract into a new contract with a lower death benefit. Then I think that would probably be considered a drop in the death benefit within the first seven years of that contract which was issued under the TAMRA rules, and then I think you'd have a look back, recomputation problem.

FROM THE FLOOR: I have a question for Tim. On the second-to-die product you said Texas was considering coming off of the exact age or there's some discussions going on?

MR. PFEIFER: Texas has gotten its companies to justify their joint equal age calculations, and also to provide evidence that their joint equal age cash values are at least as large as their exact age cash values.

FROM THE FLOOR: So there are still a lot of details and demonstrations involved. It's not a total, you can use joint age. You still have to do quite a detailed comparison with exact calculations.

MR. PFEIFER: Right. As I say though, there is some negotiation that's going on with companies that want to work out something that's more reasonable than that. There are two other states, I think New Jersey and Washington, that were also acting along those same lines as Texas.

FROM THE FLOOR: On the policy split option, do you think most companies do not require evidence, or are there a few companies that do require evidence when you split the policies?

MR. PFEIFER: There are a few that do.

FROM THE FLOOR: That's not uncommon?

MR. PFEIFER: No, it's not uncommon. I think the trend though is not to.

FROM THE FLOOR: Do most of them just say 50-50 or is there a variable split?

MR. PFEIFER: There can be a variable split.

FROM THE FLOOR: Evidence free generally?

MR. PFEIFER: Yes, but usually 50-50 is the standard.

FROM THE FLOOR: One priced one that allows a variable split with no evidence? It seems like that would be a reel-risky thing to price.

MR. PFEIFER: I don't see many of that.

MR. ADNEY: With regard to the tax treatment of the joint and last survivor policy, I think there is a lot of interest in the last-to-die market. It obviously serves a very important and legitimate need, but you should be aware of the fact that there are questions about how the product will be taxed, and in particular, how the guideline or net single-premium is to be calculated. No rules have ever been articulated on the subject. In fact, the 1989 Kennelly Amendment referring to the second-to-die policy was the first time we had any clarification that the policy was allowed to be written under the definition of life insurance. But, the question that will come up is, how do you apply the maturity date rule of Section 7702A to a joint last survivor policy when you have potential insureds who do not quite fit within the rule that says the policy must mature under calculations not earlier than the insured is age 95 and not later than the insured is age 100? Who is the insured that the statute is referring to? Is it the joint equal age, which makes some sense, or is it the younger of the insureds or the older of the insureds? You can come up with a variety of hypothetical questions of that nature, but they are going to be important questions. I think people should realize that the Internal Revenue Service is going to say something about this. It may or may not be what you're assuming, and the people there are going to need guidance on it. People who are interested in that should talk to the ACLI and may very well want to consider talking to the Internal Revenue Service about that before it makes any final decisions on the 7702A regulations.

MR. DESROCHERS: Any other questions?

FROM THE FLOOR: I have a question on the universal life. What's the latest study on the lapse rate of universal life, and how serious a concern is lapse rate impact on profitability? In Canada it's quite a serious concern.

MR. DESROCHERS: In the studies that we've seen, one of the difficulties is the definition of "lapse." A very large number of companies study surrenders, and the rates that we see used are rates of the policies either surrendering or "falling apart" through run off of the cost of insurance. The early year surrender rates are quite low, and tend to increase by duration. Premium persistency, is really more like a traditional contract lapse rate. But, unfortunately, there isn't much agreement as to how one goes about measuring persistency because the whole idea of the product is for premium flexibility. I'm not sure that there had been many extensive studies done. Most of the studies that I have seen have been individual company experience, and there you do tend to see quite a bit different pattern than in a traditional product.