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VARIABLE PRODUCTS UPDATE

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Panelist: JOHN M. FENTON
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Some issues to be discussed by the panel are life and annuity product design, pricing compensation, and reserving issues related to variable products. The moderator will do the questioning and seek responses from the floor.

MR. JOHN M. FENTON: I am with Tillinghast in the Atlanta office. Joining me is Steve Roth of Sutherland, Asbill and Brennan. I will give Steve's background later. Originally we were going to have a third speaker, Gordon Boronow, but Gordon is sick and cannot be with us.

This session is meant to be interactive. We definitely want to get the audience involved asking questions and offering comments. I plan to make a short presentation, followed by Steve who will do the same. Then we will turn the session over to question and answers.

We can now move onto my presentation. The title of my talk is Update on the Variable Product Marketplace. The areas I would like to cover include the following:

- State of the variable market
- Product trends
- Fund issues
- Future of variable products

STATE OF THE VARIABLE MARKET

As I think virtually everyone is aware of, there has been a dramatic increase in variable annuity sales over the past several years. Table 1 shows the sales figures for the past five years. The total market reached \$45.5 billion in 1993, which is about a 59% increase over 1992. Results are shown with and without TIAA-CREF. TIAA-CREF is a major player in the market and has only recently started contributing sales results. That is why we have split the results out.

If we look at the results without TIAA-CREF, we see that the market has increased about fourfold over a five-year period from \$8.5 billion in 1989 to \$40.5 billion by 1993, which is an average annual increase of about 50%. There are about 55 companies by my count who are active in the market at this particular time, although this increases almost monthly.

In terms of 1993 sales, we note that approximately 50% of the business comes from qualified plans which is down somewhat from the 56-59% figures that we saw for several years. So there is a small shift away from qualified monies.

*Mr. Roth, not a member of the sponsoring organizations, is Partner at Sutherland, Asbill & Brennan in Washington, D.C.

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TABLE 1
 DRAMATIC INCREASE IN VARIABLE ANNUITY SALES¹
 (\$ BILLIONS)

Years	With TIAA-CREF		Without TIAA-CREF	
	Total Premiums	Growth	Total Premiums	Growth
1989	-	-	\$8.5	
1990	-	-	12.5	47%
1991	-	-	16.0	28
1992	\$28.7	-	24.1	51
1993 ²	45.5	59%	40.5	68

¹ Source: Tillinghast VALUE Survey, includes total premium, fixed and variable account

² Breakdown of 1993 sales—Qualified: 50% Fixed account: 25%.

Fixed account business is included here and accounts for about 25% of the total sales. Again, this is down somewhat from a year or so ago.

The source for these data is the Tillinghast VALUE survey which includes total premiums and both fixed and variable account business. We have just received some results for the first quarter of 1994. Total sales are \$15 billion, which is up almost 60% over the first quarter of 1993. Therefore, the market is continuing to move ahead despite the somewhat weak stock and bond markets.

Let us now take a look at who is selling variable annuities. Tillinghast has done a study of the distribution channels used to sell variable annuities. Table 2 shows results for 1992, as well as some preliminary results for 1993. It is important to note that the 1993 results include estimates for a number of companies; therefore, this is subject to change.

TABLE 2
 VARIABLE ANNUITY DISTRIBUTION BY CHANNEL¹

Distribution Channel	1992	1993(est.)
Agency force	36%	29%
Stockbrokers	30	41
Financial planners	8	9
Banks/savings and loans	5	5
Direct response	4	3
Other	17	13
Total	100%	100%

¹ Source: Tillinghast Survey, 1993 results include estimates for some companies

The distribution channels shown are agency forces, stockbrokers, financial planners, banks and savings and loans, direct response, and other. A few observations on the study. First, on the 1992 results, we have recategorized these to some extent over what was presented earlier. For example, we have moved some business from

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financial planners to agency forces to better reflect the definition used by most companies. We have also added results for TIAA-CREF, which is shown as Other.

If we compare results for 1993 with 1992, we see the biggest growth is for stockbrokers who have increased their share by about 11 points. Conversely, agency forces have lost seven points and Other has lost four points. This reflects a large increase in sales of stockbrokers selling nonqualified business. Qualified business tends to be sold more so by agency forces. This shift to stockbrokers reflects *dramatic and explosive growth in the nonqualified side*. Qualified business shows strong growth, but not quite as dramatic.

Financial planners are stable at 9%, but this is one distribution channel that is getting much attention right now. There is much activity going on right now in the banks. While they account for only 5% of variable annuity sales, the banks are a big player in the fixed annuity market. Over 30% of fixed annuity sales are through banks. Therefore, I think banks have the potential to get in this market in a big way.

In particular, some of the larger banks are interested in wrapping their funds in the product. There are some critical mass issues that they have to face, but I think they are definitely going to be a player in this market going forward.

Let us now take a look at why variable annuity products have been so successful. I think the number one reason is that the low interest rate environment has pushed consumers to equity products overall. Returns on fixed-income products, CDs, and fixed annuities are not that attractive right now; consumers are searching for yield. They are willing to take the risk (either knowingly or unknowingly) to get the higher returns from variable products. Of course, we have seen a market correction in the first quarter. However, this has not slowed sales yet.

We note that variable annuities compete favorably with mutual funds because of the tax deferral on the nonqualified side, as well as the guarantees in the product. This includes guaranteed minimum death benefit (GMDB), fixed account, and settlement options.

In the nonqualified market we find that the tax deferral generally outweighs the higher fees on variable annuities, over a longer-term horizon. This varies depending on a number of factors, including your current tax bracket and ultimate tax bracket, as well as what type of fund you are in.

Everyone perceives that variable annuities are higher fee products, which is generally true. But I would say that you need to make sure the comparison is valid in terms of load structure of variable annuities versus mutual funds. Oftentimes, this is confused.

Aside from this, I would say the reason that variable annuities are more expensive is because they generally pay higher commissions relative to mutual funds. Therefore, it is the distribution costs that drive the higher fees. My point is, I do not think the variable annuity product is inherently more expensive—it is driven by higher distribution costs.

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What else do we see in the market? We see that the competition for marketshare is intensifying. There are a number of new entrants in the market. Steve will address that later on. There appears to be a push to gain marketshare. Compensation tends to be moving up a bit, either permanently or temporarily through specials. It appears that new entrants are willing to accept somewhat lower profits initially to get a foothold in the market.

Overall, I would say that distribution is definitely still the name of the game. Success of the product is driven by distribution. The wholesalers' relationships with the retail sales force is very important.

Finally, another major selling point in variable annuities is the fund management side. Variable annuities provide access to brand name or specialty fund managers with a variety of choice. I would say that funds are a major selling point to consumers, as they tend to look more at fund options than at product features.

I believe product features are probably more important to distributors, when they try to define which product to sell. But I think offering either a well-known brand name fund manager, such as Fidelity, Oppenheimer, Dreyfus, or a specialized fund manager with appeal to a certain market, is one of the ways to get ahead in this market.

Let us talk about variable life for a while. We see again that there has been a large increase in the variable life market as well. It is not quite as large as variable annuities, but still quite strong. Table 3 shows variable life sales over the past five years, split by annual premium, single premium, and dump-ins. We see that the market for 1993 reached total sales of \$1.7 billion, which is a 24% increase over the prior year. This comes on the heels of a 40% increase over 1991. The market has essentially doubled in the past five years. Please note that sales listed here are first-year premiums only.

TABLE 3
SIGNIFICANT INCREASE IN VARIABLE LIFE SALES¹
(\$ MILLIONS)

Year	Annual Premium	Single Premium and Dump-Ins	Total Premiums	Growth
1989	\$500	\$350	\$850	-
1990	650	400	1,050	24%
1991	625	275	900	(14)
1992	965	300	1,265	40
1993 ²	1,485	205	1,690	34

¹ Source: Tillinghast VALUE Survey, includes first-year premiums only, fixed and variable account

² Breakdown of 1993 sales—Fixed account: 13%

As of the end of 1993, variable life accounted for about 17% of total individual life sales. With some of the results that we are seeing in this quarter, this figure will probably come closer to 20%.

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Most of the growth is in the annual premium sales. Single premiums are still very small, and dump-ins have fluctuated to some extent. But the largest growth is in the annual premium figures.

Right now, the fixed account is about 13% of total sales, which is lower than variable annuity. Therefore, it is not an important part of the product right now.

In the first quarter of 1994, we saw sales that totaled \$500 million, which is a 63% increase over the first quarter of 1993. So again, the variable life market is moving ahead as well.

What is driving the success of variable life? Again, similar to variable annuities, they have low interest rates. Dividend rates on traditional products and credited rates on universal life are not that attractive. They continue to fail to some extent, as they are mostly portfolio-rate driven. Variable life products have offered better returns more recently.

We still see the success coming from companies with a captive agency force. Four companies—Prudential, Equitable, IDS, and Metropolitan—account for over 50% of total sales. In the past, they have been the big story in the market. However, now sales are also expanding to companies who use independent agents.

For now, most of these "independent" agents tend to be controlled through a retail broker dealer. I think this may eventually change; we will talk about this later.

Another item that we see in the variable life market is that companies that have been in it for a while find out that it is not good enough just to have one variable life product. You need several products, including perhaps a high-premium product, a low-premium product, and a last-survivor product. You might also need a product for the corporate-owned life insurance (COLI) market. Therefore, we are seeing expansion of the product line.

Variable products are attractive to senior management. They have locked-in interest spreads. You always receive your asset charges, whereas we know in the fixed products that is not always the case. There are also low risk-based capital requirements. Essentially there is no C-1 or C-3 component on a separate account. Therefore, there is less demand on valuable capital. Finally, it gives companies the ability to control their agents; they can be tied to your broker/dealer. They cannot broker business unless you give them permission to do that.

Another area of interest is those agents who are personal-producing general agents (PPGA). They are used to selling a number of different products. They are going to want product choice down the road. This may lead to the creation of regional independent broker/dealers, who work with a number of different companies to offer various products.

PRODUCT TRENDS

Let us now take a look at some of the product trends that we are seeing in the variable product side. First, what do we see on the variable annuity side? I would say overall there is a tendency to have higher asset charges—total product asset

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charges, which include the mortality and expense (M&E) risk charge and the administration charge. Initially these were at the 125-basis-point level, but have now moved up to 140 basis points. More recently, we have even started to see a level somewhat higher than 140 basis points. This can be done through a separate GMDB load, or a separate distribution load, or perhaps even higher administrative charges.

What we found is that these higher charges are generally used to increase compensation and provide an enhanced GMDB. Companies are now finding out that this is not a freebie. We are going to talk more about that later on. Something else that we see is alternative pricing structures. We are seeing some no-load products and by that I mean no surrender charge products. There are generally two types. The first is one with a high asset charge and paying a high level of compensation, say 100 basis points each year. Alternatively, there are products designed more for the direct-response market, where they tend to have lower asset charges. Schwab has just come out with a no-load product with Transamerica. It is going to be interesting to see how it plays out.

I think we will also see more interest in exchange products, as monies move out of fixed annuities. There is a demand to move out of fixed annuities without a surrender charge. I think one other thing we are going to see is alternative loading structures. The mutual funds created A and B shares several years ago. A is front-end loaded and B is back-end loaded (it looks like a variable annuity). There are a limited number of front-end loaded A-share variable annuities out there. The mutual funds have now also gone to C and D types of shares. I would not be surprised to see variable annuity products go in the same direction over the next few years.

Steve, I do not know if you have any thoughts on that in terms of what one might see in the future.

MR. STEPHEN E. ROTH: What is interesting is that mutual funds, because of the way they are regulated and the 1940 Act, have to go in and get exemptive relief to issue different classes of shares. But because of the way separate accounts are structured and they are registered as a different type of investment company, you can have any number of classes of units in a separate account and not really have to jump through any special hoops at the Federal Trade Commission (FTC).

MR. FENTON: Moving on to variable annuitization. There has been much discussion about this in the past. It keeps being projected to be the big wave of the future, but it has not been so far. I do think it will become popular some day, but not in the immediate future. I think there is really too much deferred money that needs to annuitize. In particular, I think we are going to see more utilization in the qualified market. Those individuals probably need the money for retirement income. Those in the nonqualified market probably do not need it as much; they can afford to hold their balances until death. One of the challenges here is a way to figure out how to pay the agent on an ongoing basis, perhaps through a trailer commission.

I think something else we might see is more use of the market-value adjustment (MVA) on the fixed account. I believe it is going to become more popular in a rising interest rate environment.

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I think customers are willing to accept an MVA if they can get attractive long-term guarantees. Six months ago, you could get a 5% rate for five years, which is not that attractive. However, as we get into the 6–7% range, I think it will attract more attention.

There are some regulatory obstacles to MVAs on the state level. Only a limited number of states allow a true MVA on an individual contract. This tends to kick you over into a group contract. There have been some problems with discretionary groups. Steve, are there any particular regulatory issues on the SEC side?

MR. ROTH: An issue that the SEC has been grappling with, and really has not yet satisfactorily resolved, is insulation. When you use a separate account to fund an MVA, can you insulate it from the liabilities with the insurance companies like variable annuities or variable life separate accounts are insulated?

There are some states that are a little queazy about the prospect, but at least the statutes appear to allow a separate account funding of a fixed or guaranteed contract to be insulated like the variable product. The SEC has indicated in some correspondence it has had with a couple of insurance companies last year that they feel once you take the extra step of insulating the separate account from liabilities, and do not just treat it as a mere accounting vehicle, you have created an investment company. Of course, once you have created an investment company, you need to comply with all of the product design restrictions in the Investment Company Act (unless you can get exemptive relief). That is a square peg in a round hole. Market value adjusted annuity contracts just do not fit into the classifications of investment companies in the Investment Company Act. Therefore, we are sort of at a dead end on that right now. There is one company in the market with this product. Other companies have been told that they will need to either register as investment companies or get adequate exemptions. And no one has really been up to the task yet to work through that maze. I think it is going to be a long and arduous process.

MR. FENTON: OK, let us move on. A very hot topic these days is the GMDB. I think the important point I want to make here is that the GMDB is not a freebie. The work that we have done shows that the cost can be significant. Also, the cost varies depending on many factors, including issue age, benefit, market expectations, and type of fund, to name some of the more important ones. Based on the research that we have done, the cost of a 5% premium accumulation benefit, with no age cut-offs, is shown in Table 4.

We see that the cost varies significantly by issue age. Results are shown for four different issue ages, as well as various fund types. For a particular fund, like the stock fund, these are the average annual costs in terms of basis points. The stock fund assumes 100% of the monies are invested in the stock fund. Similarly, the bond costs also assume 100% is invested in bonds; the same applies for money market. The average is simply a straight weighted average based on 60% stock, 30% fixed income, and 10% money market.

The weighted average cost is 20 basis points. This corresponds to an average issue age of say 61. Obviously, the 20-basis-point cost is not a trivial amount.

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TABLE 4
GMDB FEATURE NOT A "FREEBIE"¹

Issue Age	Stock	Bond	Money Market	Average	Diversified
50	7	2	7	6	4
60	16	5	15	13	9
70	42	13	36	33	23
75	65	21	54	51	36
Average	26	8	22	20	14

¹ Cost varies by issue age, benefit, market expectations and type of fund. Average cost of 5% premium accumulation. Numbers shown are in Basis Points.

Instead of investing fully in stock, bond, or money market funds, we have studied the impact of each policyholder diversifying, and we used the same weights that I showed before. The advantages of diversification are that the cost reduces from 20 basis points down to 14 basis points, which is about a one-third drop.

We have found the cost is heavily dependent on issue age. If we increase the average age by just three years, the 20 basis points increase to about 26 basis points, which is quite a large increase.

A few footnotes on the cost. These are levelized costs over a 20-year period. It is calculated as the present value of the excess death benefit divided by the present value of the account value. It should be noted that there is significant volatility by scenario. The 90th percentile cost is probably two or three times higher than the mean cost. It should also be noted that these do not reflect the cost of holding reserves or target surplus.

I think many of you would agree that it is probably difficult to absorb 20–25 basis points in your pricing. Therefore, you need to look at the methods available to manage the cost. One possibility is to restrict the benefit at the older ages. If you put a cap on the accumulation at say age 80, the 20-basis-point cost goes to 17 basis points. If you cap it at age 75, the 20-basis-point cost goes to 12 basis points.

Another possibility is to have a separate GMDB load. I think Steve will address some of the issues involved with this later on. Another possibility is to use reinsurance. Of course, this may not necessarily reduce your cost, but at least it reduces the volatility.

As a final point, the numbers that we have shown here are what we call the initial conditions scenario, which reflects today's capital market conditions, moving to a more normative market over time. The normative market would reflect more historical averages in the capital markets. We believe the initial conditions scenario is the appropriate scenario to look at for policies sold today. However, if you ignore today's marketplace and look at a more normative type of scenario, you find the cost is only one-half to two-thirds of what is shown here. So if you take the long-term perspective, you may think that the costs are lesser than what we have shown here.

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In addition to the 5% premium accumulation, there are other GMDB benefits that are out there. Another common type is the five- and seven-year ratchet. Prior work that we have done shows that it is roughly half as expensive as the 5% premium accumulation. Hartford has now come out with a one-year ratchet. This might cost as much as the 5% premium accumulation. These costs vary a great deal by type of fund—and for the ratchet there is virtually no cost in money market; however, the stock fund costs are quite high.

There is also a 7% accumulation benefit, which is quite expensive. This may be up to two times more expensive than the 5% accumulation. I think this provides you some idea of the range of cost on the GMDB feature.

Let us now turn to the variable life side for a while. On variable life we see continuing pressure for competitive illustration values. The most common type of illustrations that we see compare cash values based on hypothetical gross earned rates, generally 12%, compared at 10 years and particularly 20 years and 30 years. There are several methods being used to improve illustrated cash values. One way is to use a declining M&E risk charge. Our pricing work shows that these can be cut back in later years, after you make your profits in the first ten years. It should be noted that there are some administrative issues involved with a declining M&E risk charge.

We also see use of lower ultimate cost of insurance (COI), with little margin over the actual experience mortality. The GMDB feature is an area that is getting some attention on variable life as well. There are several different types available. The most common one is a no lapse guarantee for two or three years, or five years in a few cases. To get this, you pay a minimum premium, which keeps the policy from lapsing. It is really not too dissimilar from a universal life type.

A truer GMDB feature extends to a higher age, either a retirement age (say age 65–80) or perhaps the whole of life. The problem with a whole of life benefit is that, depending on how you interpret the model regulation, it can generate high GMDB reserves. This can be minimized by requiring higher premium levels, but these can get quite high.

With the tax law scare that we have seen recently on the annuity side, there has been some interest in investment-oriented life products, particularly single premium life. I believe there is still a need for these products. A significant percentage of all annuity sales are actually held until death. For these people, a life product would probably provide a better return.

We also see more use of the variable last-survivor product. There are currently four or five products out there right now, and several more are under development. I think we are going to see more activity in this area. I believe there is at least one first-to-die product out there. There may also be more development here.

FUND ISSUES

We are going to just touch upon some of the fund issues, because I want to move on with our session. What we see on the fund side is the explosion of the multi-manager approach. The concept is take the best of the best by using several different fund managers. Certain fund managers are better known for managing

certain types of money. We also see an increased focus on performance. Name recognition still means something, but it is less important as there are more and more funds with three- to five-year track records. This can make a big difference in pricing your product. Another issue that Steve will get into in more detail later is deriving profit from the funds management side in your product.

FUTURE OF VARIABLE PRODUCTS

What does the future hold for variable products? I believe that variable products will continue to thrive in today's moderately low interest rate environment. Given the pace of first quarter sales, we predict that 1994 variable annuity sales will easily exceed \$60 billion. And if we keep at current run rates, it should be closer to \$70 billion. That compares to \$45 billion for last year.

On the variable life side, sales will probably exceed \$2 billion, moving up towards \$2.5 billion. The market correction has created some concern, given that the market has dropped 5-10% since January. But apparently it has not slowed sales or increased redemptions, which has been the case on the mutual fund side. If the correction widens, it may present more of a problem.

What is probably more of a risk factor here is the loss of the favorable tax treatment on nonqualified annuities. The industry has apparently just fought back one challenge. However, I think there are likely to be others over time. I think it is possible that within the next three to four years, the tax advantages of annuities will be restricted or perhaps eliminated. This would obviously be a definite concern to a nonqualified market. I do feel comfortable with the tax status of life insurance. I think the tax deferral is reasonably safe.

In other areas, I believe the current push to gain marketshare will in time be replaced by product rationalization. Companies will be more focused on profitability and expense levels. Companies will realize they need to make money in this market. To do this, they need to reach critical mass, and probably tighten up on expenses, and keep their compensation in line. And I think that some companies eventually will realize that variable is not the place for them, which will cause them to leave the business.

I think persistency, particularly on variable annuities, will be a big issue in the next few years. Right now, there is a very limited amount of variable annuity business out of the surrender charge period. Soon there will be more business coming out of the surrender charge period. This poses a potential problem to some companies, for example, those who have had poor fund performance or are in a somewhat weakened financial condition. This later point is still an issue, even though it is separate account business, primarily because of the fixed account. Persistency is also a concern to companies that are not paying a trailer commission. Another risk factor exists for companies who are no longer selling through the same distribution channel that the business was placed. Overall, I think we will see more attention paid to persistency, and probably the spawning of programs designed to enhance and protect blocks of business.

In conclusion, I think that variable products are likely to increase marketshare over time, although there will be ups and downs. We have to remember that we have

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gone through a good up period recently. However, in the long term, we have to remember that it is in the policyholder's best interest to be in a variable product because of the higher returns that are available on equity and international funds relative to fixed-income funds. Given the long-term horizon for annuities and insurance, I believe variable products make sense in the insurance and annuity arena.

That concludes my remarks. I will take one or two questions if anyone has them.

MR. MICHAEL E. DUBOIS: On the profitability levels that are expected, what are we seeing for return on assets or for return on capital for these products? And does it vary between the separate account and the fixed account that are within them?

MR. FENTON: That is a good question. Let us focus on variable annuities. When you look at profitability on a variable annuity product, some of the measures that have been used in the past, like ROI, become less meaningful because there is very little investment.

A measure that has become more common is the return on assets or the present value of profits divided by the present value of assets. Now, it is important when you are doing this calculation to look at your discount rate. There will be a big difference if you are using a 6% rate or a 12% rate. If you are somewhere in the 6–9% range, I would say that you would see return on assets ranging from 15 to 20 basis points after tax and target surplus.

I would say that is the rough range. In terms of ROI, it is reasonably easy to earn a 15–18% ROI on these types of products. I think if you reflected the true target surplus, returns would probably be less for fixed-account business.

We are now going to move on to Steve Roth's presentation. Let me tell you a little bit about Steve. Steve Roth is a partner with the law firm of Sutherland, Asbill and Brennan in Washington D.C. He engages in corporate securities and insurance practice, with primary emphasis on insurance company securities, regulatory and transactional matters.

Steve is a leading expert in the development of variable products registered with the SEC. He was the principal draftsman of what is now rule 6e-3(CT), which currently governs the design of Variable Universal Life (VUL) products. He is also a recognized expert in the development of regulation of mutual funds, as well as the establishment and operation of broker/dealers and investment advisors.

MR. ROTH: I am happy to be here. I guess the best news of the day, which you probably have already heard, is that President Clinton has apparently taken the proposal to limit contributions to annuity products off the table as far as a revenue raiser for his welfare reform legislation. That is obviously good news, although because it is not signed, things can always change. It is still possible that it could be on the table as a revenue raiser for the GATT legislation, assuming that moves forward this year.

What I am going to talk about is a little more mundane—the nuts and bolts of SEC regulatory developments. The significance of those developments probably pales in

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comparison to the tax issue. But I think there are a number of interesting developments and a number of good developments in terms of increased flexibility in product design and marketing.

I first want to talk about developments related to product design, and then move to the marketing side of the equation.

In any event, one thing you have probably heard about for the last several years is this 1940 Act study report recommendation. So I will start off with that—what is the status? What I am referring to is a report that was issued a couple of years ago. The SEC staff recommended that the Investment Company Act be amended, in the case of variable products, to do away with the regulatory charge scheme that companies must now deal with, and replace it with a more generous, if you will, regulatory framework that would simply require that all of the charges in the aggregate, under a variable product, be reasonable relative to the risks assumed, the services provided and the expenses incurred.

Everybody was pretty excited about that. It came out in May 1992. Ultimately, however, it did not go anywhere, so unfortunately the message I have for you is that it is essentially dead in the water. If you are waiting for changes here to develop a product, I would not wait any longer. That does not mean to say that we might not see some action here at some point. But what has happened is there has been a change of administration. We have a new SEC chairman and a significant change in SEC staff. Very few of the SEC staff people that worked on this proposal are now there. The new chairman has his own set of priorities, such as market reform, derivatives, internationalization of markets, and insider trading.

Reform or update of the Investment Company Act is not on his short list at this point. It is possible that the proposal could pick up steam in the future. But I would give it less than a 50/50 shot at this juncture.

So let us turn from that to the world we have to live with and that is the current regulatory framework that is largely prescribed by the Investment Company Act of 1940. I want to address several recent developments. And I would be happy to take any questions that you may have about each of these developments as I go through them.

First, John referenced the higher M&E risk charge. The background here is that for years dating back to the mid 1980s, the staff indicated that they did not feel comfortable with M&E risk charges above certain arbitrary caps. The cap for variable annuities was 125 basis points. The cap for variable life insurance depended on the type of product: 50 basis points for the old scheduled premium products, 90 basis points for VUL and flexible premium products, and 60 basis points for hybrid products that are sort of in between.

After the study report recommendation came out, we did see a loosening in the staff's attitude toward this. They have indicated that in their view the caps are off. They are prepared to grant exemptive relief for higher M&E risk charges, where it can be shown that there are additional risks being assumed by the insurance company that essentially were not around back when they set the caps.

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The primary and essentially only example of that so far is an additional charge for the enhanced death benefit under a variable annuity product. You know more about the design of that probably than I do, but as a general matter, it usually involved a guarantee of premiums plus some stated rate of interest between 4% and 8%. John has already talked about the actuarial underpinnings of that.

What are the SEC issues? Well, you do need relief to obtain the higher charge. There are now five companies that have obtained relief. The charges range from an additional 12 to 35 basis points. Again the interest rates range from 4% to 8%. It has not been that difficult to obtain this relief. For the first or second applicants that came in, the staff asked to see the back up actuarial memoranda supporting the charge. But in the last couple of applications, they have not. They have simply relied on the arguments made in the formal exemptive application itself.

Those applications do explain in some depth, in a page or two, the methodology that the company used to justify the level of the charge. I think all of them have stated that they did several thousand simulations in order to get comfortable with the level of the charge. You are not going to find that it is necessary to put this in a matrix or whatever. I think that is good. In other words, there is no sign at this point that the staff is saying, at a 6% benefit, you must have no more than say 7% or 8%. They are basically relying on the representations of the company and the market to regulate this.

The staff has also indicated that they are receptive to higher M&E charges on the VUL side. To date, as far as I know, no one has taken them up on that challenge. But I think the door is open. One could envision, for example, a single-premium product (guaranteed or simplified issue), in which, instead of charging a higher mortality charge, you try reaching your target rate of return through a higher spread or through a higher M&E charge. I think the staff would be quite receptive to that kind of argument.

So, at this point we have not really seen any higher M&E risk charges for variable life. What we have seen, however, is a breakthrough of sorts for another type of charge for variable life. And it has been labeled a charge for deferred acquisition cost (DAC) tax costs. What I am talking about here, of course, are the increased time value of money costs that insurance companies must bear as a result of the enactment of Section 848 of the Internal Revenue Code.

The issue here from a regulatory perspective is whether, if you assess a charge to cover those increased costs, that charge needs to be treated as a sales load? And if so, do you still fall within the sales load cap that you otherwise have to meet? The answer is, without exemptive relief, it does have to be treated as a sales load.

You may have a situation where your sales loads are otherwise bumping up against the sales load limits. For example, the refund rules in the first two years effectively limit sales loads to 30% of the first guideline premium, plus 10% of the second guideline premium. If you are there already and you want to add an additional charge to cover DAC tax costs, you are not going to be able to do that without exposing yourself to the sales load refund rules. So you would probably want to apply for and get exemptive relief on the charge so that it would not be treated as a sales load.

The charges so far have been generally uniform at 1.25% of premiums. There are a couple of applications pending for higher amounts—one at 1.38% and another at 1.50%. There is no apparent indication that the staff is balking at those. The justification for the charge is the 7.70% number in section 848, the corporate tax rate, and the discount rate. Together this gives you a number that you discount back to as a percentage of premium. Given a corporate tax rate of 7.70% and a discount rate of anything 10% or above, you are going to end up with a DAC tax charge of something well over 1.25%.

What has the issue been here? Well, the issue the staff struggled with for a long time was what is the appropriate discount rate to use? Initially they felt that the appropriate rate was either a backward-looking average 10-year bond rate or a current 10-year bond rate of some sort. But after thinking about it further, they ultimately determined that the appropriate benchmark for discounting was the insurer's actual cost of capital. It was determined that this was the right way and anything else was the wrong way.

Therefore, the insurers that have gone in for exemptive relief have had to lay out in any great detail their methodology for computing their cost of capital, or at least indicate the range of the cost of capital. Most insurers have not disclosed their actual cost of capital, but they have indicated that it is in excess of 10%.

In addition to laying all that out, the company must represent that the charge is reasonable in relation to the cost the company is assuming here, and that they will continue to monitor the reasonableness of the charge. This is not necessarily a fixed charge. It would float if federal income tax rates changed, or if the cost of capital changed, or if the 7.70% rate changed. An actuarial opinion must be filed as an exhibit. That opinion must address the reasonableness of the charge, the cost of capital formula, and the appropriateness of the factors used by the company to determine its cost of capital. Overall, this is a good result, although fairly technical. The staff is still micro managing here a little bit.

The next general area I want to touch on is variations in sales loads. The Investment Company Act generally stands for the following proposition: sales loads should be within prescribed limits and should be simple and uniform.

Well, the loads on these variable life products in particular are not usually very simple, particularly if you have a high first-year commission to pay. The staff, however, has been increasingly willing to give exemptions from the statutory provisions that require simplicity. What I am referring to here is a requirement that loads meet a stair-step rule.

A variant on that is that they not increase over time. So the staff has been very willing to grant exemptive relief to variable life insurance issuers that want to charge lower sales loads on dump-in premiums or premiums over a target in a particular year; an example is unscheduled premiums on a hybrid product. You do need technical relief there, but there has been no indication that they are going to balk at that sort of thing. That was not the case a few years ago. They wanted rigid adherence to this nonincrease rule.

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On the other hand, on the variable annuity side, we have seen some increased concern about waivers of sales loads like nursing home riders and terminal illness riders. The standard that the SEC employs here is that you can vary your loads if the variance is nondiscriminatory and is related to differences in costs of services provided.

Well, most nursing home waivers, for example, do not really have any bearing on differences in cost. The staff has picked up on that and they indicated that something may need to be done here. They have not been carrying a big stick on this one, however. They have allowed companies to proceed with these. But they have indicated that they are studying the matter and that they may require companies to jump through some hoops on the action letter and exemptive action application before they could continue assessing these charges. So, we may see developments here, but I doubt that it will really affect the product design.

I am going to skip over the subject of asset allocation services. It might be something that some of you have an interest in and could discuss in the question and answer part of the presentation. An area that I am seeing increased interest in is companies that want to provide a vehicle within their product to assist the contract holder in moving money around and then assess a charge. And, of course, there are also dollar-cost averaging and automatic-balancing features. What I am talking about here is a more discretionary service that would be provided by the insurance company or investment advisor. There are several products out there with services like this now. A couple of them assess the charge at the contract level for this. There are some SEC and tax issues associated with that.

I want to spend more time on a subject of more general interest which is what are the vehicles for getting revenues from an underlying fund to help you meet your profit objectives or pricing objectives? There are a number of ways to get revenues from the underlying fund, and we have seen much interest in this.

There has been one notable change that I have perceived in just the last couple of years. A few years ago, when there were only a handful of fund sponsors with insurance product funds, it was very much a seller's market, if you will. You took what the fund sponsors gave you and there were no questions asked. But now there are many players in this market. There are very few major fund complexes that do not have their own insurance products fund and many minor niche players that also have created their funds.

Many of these fund managers are looking for distribution. And any time a fund manager is looking for distribution they are going to be willing to sit down and talk about possible revenue enhancers that the insurance company needs in order to make its product profitable.

Well, there are regulatory issues associated with this general subject, and that is what I want to touch on. The first way to potentially get enhanced revenue is through a 12b-1 plan at the fund level. I assume most of you are generally familiar with that concept. Many public mutual funds have 12b-1 plans that are approved by the fund board to pay distribution expenses out of its assets.

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Insurance product funds do not have such plans. The reason for that is that the staff does not like them. One company pursued this idea a few years ago with the staff, and was told bluntly that the staff would not approve it.

The proposal they had was that the fund would adopt a 12b-1 plan for, I believe, 20 or 25 basis points. This amount would be paid directly to the insurance company, to help them defray their distribution costs. The staff felt that was an inappropriate use of the 12b-1 vehicle. That is because the insurance company had a controlling interest in the fund; it owned more than 5% of the fund shares. Therefore, it violated some self dealing provisions in the 1940 Act.

However, recently one fund did get a 12b-1 plan through, although it is a more limited plan. It is what is known as a reimbursement plan. The fund under this plan pays for the cost of fund prospectus, sales literature and advertisements related to the fund, and the costs of fund personnel attending training sessions and client meetings. What it does not involve is that fund paying compensation to the insurance company, which the insurance company can use for its own purposes. But it is a crack in the door, so to speak, because many times the insurance company gets stuck with some of these advertisement and prospectus printing costs. In this particular case, it was a 25-basis-point, 12b-1 plan with an initial eight or nine basis point assessment.

So what is the outlook for 12b-1 plans? Well, I would say this is a potential avenue to pursue. But if you are looking for a payment directly to the insurance company under a 12b-1 plan, there are going to be some serious regulatory hurdles that you are going to have to overcome.

An easier route to pursue is to seek payment from the fund's advisor, out of their profits to the insurance company. One theory for such a payment would be that the fund manager is incurring less costs to run this type of a fund than it would for a public fund, where the fund manager basically has to handle all the shareholder servicing. Here it is being handled by the insurance company. In this situation, it is the insurance company that acts as the shareholder. The fund has only one account—the insurance company's separate account. So, if the fund is charging the same advisory fee it charges on its public funds, it is earning more money than it is used to and may be willing to give the insurance company a piece of that.

The problem with this arrangement from a business standpoint is that it is uncertain. Can you count on it? The fund manager can revoke this arrangement at any time. There is usually no binding agreement that obligates the fund manager to do this. If you are pricing your product and counting on this, and the fund manager decides down the road that it is no longer prepared to do this, you may be caught in a real bind.

The same can be said of the next alternative. And that is to get a payment directly from the fund for administrative services rather than for distribution. Here the issue is going to be, again, what are the services the insurance company is providing? Is the charge reasonable in relation to the services? Is the fund board comfortable paying the insurance company this amount for what the insurance company is doing?

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The insurance company may be doing pricing for the fund. The insurance company may be keeping some records that the fund would otherwise keep, all of which the insurance company can legitimately be compensated for.

Perhaps the most common and most lucrative vehicle for getting revenues from the fund is through an advisor/subadvisor relationship. It is certainly the most straightforward means of getting revenues. It has the fewest legal issues, but it also requires the most work. It requires the most work because the insurance company must sponsor the fund, organize it and establish it. It is also responsible to put its entity in as the investment manager or investment advisor for the fund, and then go out and hire subadvisors. The insurance company can then keep the difference between the advisory fee and the subadvisory fee. You will see a spread between the advisory and subadvisory fee anywhere from 20 to 40 basis points.

The insurance company has to be doing something to keep that. As the fund's manager or advisor, the insurance company is responsible for overall administration of the fund. It is responsible for compliance and administration, although it can subcontract some of that out. The fund board is going to have to feel comfortable that the fee being retained by the insurance company is reasonable. But I think you have more comfort here because the insurance company can pick the board initially; it is sponsoring the fund. You are in a different situation than when you are dealing with an outside fund that has been preestablished and is selling to a number of insurance companies. Of course, your fund board will need to have a certain number of disinterested directors.

The big unknown variable here is whether you are going to be successful enough for this fund to reach the economies of scale necessary for it to be profitable. I mean there are different numbers on that. The figure I have heard is \$100 million per portfolio, or perhaps higher. John, have you any comments?

MR. FENTON: Well I would say there are obviously certain start-up costs that would take a while to recover. Another issue is whether you can fully charge the fund operating expenses, which tend to be \$20-30 million per fund. Then there are other costs over and above that, so it could easily be as much as \$40 or \$50 million, and this does not include recapturing the initial investment. Overall, \$100 million is not an unreasonable figure.

MR. ROTH: But we have seen a number of companies utilize this structure successfully. And we are certainly hearing more discussion about it in product development.

MR. FENTON: Obviously, if you incorporate an extra 20 basis points of spread from investment operations in the pricing of your variable annuity, it makes a huge difference in terms of profitability.

MR. ROTH: Now, I would like to hit just a few of the points on marketing developments. First, there are some new National Association of Securities Dealers (NASD) guidelines that apply to variable life and variable annuity products. A couple of them are more interesting in terms of marketing products. First, they make it very clear that the product has to be clearly identified as either a life product or an annuity

product. It cannot be pitched as a short-term, liquid investment. You have to be very careful about how you use ratings of the insurance company in the context of this kind of a marketing effort. The ratings have no bearing on the separate account performance and that must be made clear.

The next point is to what extent can you use fund performance that predates the inclusion of the fund in your product? Answer—if the fund is an insurance product that you are actually adding to your product that has been around for a while. You can use the fund's track record in your marketing, but you have to reflect all of the insurance company's charges. In other words, assume the product was available back when the fund commenced operations. You can compute performance numbers on that basis, and neither the NASD nor the SEC has a problem with that.

What the NASD has a problem with, and what the SEC is less comfortable with, is advertising actual performance for clone funds. In other words, you go to fund manager X and say, "I would like you to set up a fund that is just like the fund you are now running that is available to the public." When you launch your product, can you go out there and market that fund's performance? The answer is no. The NASD will not approve any sales literature with clone fund performance in it. Interestingly, the SEC will allow such performance information in a prospectus for the first year, but it is not permitted in sales material or advertising.

Another marketing issue on variable annuities is tax deferral charts. You see them all the time for fixed and variable products. The SEC does not like them. It has insinuated that it may prohibit them, but it has not done anything to date about it. It has made it clear that it feels all charges and expenses as well as the tax ramifications of early withdrawals or surrenders must be reflected in those charts. But so far they have not come out with any final decision. The NASD has not really had a problem with them.

Another issue is hypothetical illustrations for variable annuities. Since the 1970s, they could not be done. These were solely within the framework of variable life. But recently the SEC staff and the NASD has allowed hypothetical illustrations for variable annuities. It is a surprising development because mutual funds generally cannot do this. You see some use of it in the retirement market for mutual funds, but generally not much. Where you see most of the activity on the variable annuities side is for variable payouts. The illustrations try to show how different assumed investment rates (AIRs) reflect the pay-out patterns. The staff feels that is good disclosure and I agree. But you are also seeing some receptivity to even hypothetical illustrations during the accumulation period.

Finally, let's turn to market developments for variable life products. There is a new prospectus proposal that has been winding its way around the SEC staff for about 15 months now. They have completed their review of the proposal that was submitted under the new form. The proposal was submitted by the ACLI in January 1993.

It would create a two-part prospectus for variable life, just like you see now for variable annuities and mutual funds. It would significantly cut down on prospectus printing costs and mailing costs. There are three issues that the staff is hung up on. First, do you need a fee table for a variable life product? The industry's proposal does

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not include a fee table. The justification for that is that there are too many charges, and it is too complicated. It is not clear whether the staff is going to agree with that or not; they probably will have some difficulty with that.

The second issue is hypothetical illustrations. What should be on the prospectus? Should it be a standardized hypothetical illustration? Everybody shows the same issue age, sex, face amount, underwriting class, premiums, and industry position? This appears to be unworkable. There is no way, with the diversity of products that is out there now, that you can come up with a standardized illustration that would enable people to compare products. Rather, it should be handled through personalized or tailored illustrations. The SEC is not all that comfortable with that either. It feels that achieving standardization is a laudable objective and I think it is wrestling with that.

The last issue is historical performance for variable life, and this is a real quagmire. The industry wants as much flexibility as possible. Right now there are specific rules governing what performance can be advertised for variable annuities and for mutual funds. There are no specific rules for variable life. So companies are trying to grapple with the uncertain regulatory environment. Some companies are taking the position out there in the market of just showing the underlying fund performance. It is clearly disclosed that is all it represents; it does not reflect any of the charges at the product level.

Other companies are reflecting some or all of their charges in the performance information that they are disseminating. The staff believes that fund-only performance is probably misleading, although it has not taken any enforcement action against anyone that is just showing fund performance. And it is still evaluating this issue. They have retrenched a little bit. Initially, they tried to stop fund-only performance. There was such an outcry from the industry that they have backed off this position and have decided to study it more.

Their initial stab is that all the charges need to be reflected. Well, how do you show a percentage number for a variable life product that reflects all of the charges when you are dealing with demographic charges like COI and sales loads that vary depending on whether it is a first-year premium or a second-year premium. It's not very easy, to say the least.

So, maybe you show some of the charges and not all. You leave the sales load and COI out. The staff feels that some sort of separate account performance or standard or formula should be developed and they are working on it.

At this point, if you are in the product development phase and are working on a prospectus, I guess the one thing I can tell you is if you file a prospectus that only has fund information in it, the staff is likely to give you a comment. Also they may not accelerate you without your at least putting in some tables of death benefits and cash values for a hypothetical policy showing or reflecting the performance on a subaccount-by-subaccount basis.

The staff is also increasingly intrigued with the internal rate of return concept. I think there is a chance that they may, in fact, require internal rates of return to be part of a

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performance dissemination in sales literature or advertising. But there is still a long way to go on that. We also have the states involved in this area, as I am sure you are aware of which ones looking at the life insurance disclosure. Unlike a couple of years ago when they looked at cost disclosure when illustrations on variable products were carved out, this time variable products are very much in the mix with all other products there. So, this is something that you are going to want to monitor closely.

MR. FENTON: Now we are going to move onto the question and answer portion of our program.

MR. BRANDT T. BROCK: I have two questions, one for each of you. The first is, you mentioned that in the return on assets (ROA) calculation, a company may use 6–9% as the discount rate. How would a company arrive at such a rate? What is the thought process?

MR. FENTON: That is a good question. I do not necessarily see any consistent methodology being used here. I guess the thought process in terms of what rate to use is that you draw parallels to the earned rates used in your pricing, either on a separate account level or a general account level. Then, we typically price variable products with earned rates in the 8–10% range, hence the 9%. On the general account, interest rates are lower, 6–7% may be the applicable rate there. That would be the underpinning for these discount rates.

MR. BROCK: My other question is it was mentioned that those with employee contracts and separate charges were running into problems with the SEC now. Is that right?

MR. ROTH: I am not sure I understand. Is that an employee contract? What I was referring to was waiving loads on monies received from employees.

MR. BROCK: You had mentioned that the SEC felt that companies could do things like that if they could justify a different set of expenses. I guess, typically with employee contracts, there would not be a commission.

MR. ROTH: Right.

MR. BROCK: So that would be a way to justify it.

MR. ROTH: That would not be a problem. The question would be, for example, what if you are waiving an administrative charge but incurring the same administrative cost for employees?

MR. FENTON: Other questions?

MR. JAMES JOSEPH REILLY: I have a question for Steve. You mentioned in the historical fund prospectus that the SEC allows you to go back to when the fund actually started, even if your insurance company joined the fund recently. Do they require that? I would be interested to know if they allow you to do that and whether it is necessary.

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MR. ROTH: That is a good question. I guess just about everybody I have worked with has wanted to do it. So I have not run across a situation where somebody has not done it. But if you read the fine print in the prospectus, you will find that kind of a calculation is usually described as something that the insurance company may do in addition to providing performance from the separate account since it commenced operation. So it is not disclosed as something they will necessarily do. It is something they might do. And I have never seen the staff comment on it, but I think you raise a very good point, because the fund has been there. And that track record is just as relevant to an investor, whether or not the separate account was investing in it or not.

MR. CHARLES S. LINN: John, you mentioned that there is increased pressure for competitive values. I was wondering how companies are going to react to the new NAIC proposal on illustrations where, at least at this point, only guarantees and historical performance can be shown. Also, what will companies that are trying to get into the market be able to do without any historical performance?

MR. FENTON: I wonder if John Hele of Merrill Lynch can address that question.

MR. JOHN C. R. HELE: The new NAIC proposal, as I understand it, is still in the draft stage, but for those of you that are unaware, it would allow only historical performance and guarantees going forward. We have been doing quite a bit of work on this within our group. Somebody who does not have a track record is at a disadvantage to somebody who has had mutual funds around for ten years; they could then do historical performance like the SEC has said.

Clearly, you would be in the same position as somebody who is starting a brand new mutual fund, who does not have a track record. Say you are starting a small new cap growth fund; you would have no track record. You have to sell it qualitatively and speak about what you are investing in and some of the underlying things that make it different. You tend to speak more about the company or whatever it would be.

This is common in the securities industry, where you cannot project out. You can only use historical results on everything from mutual funds to stocks or whatever. Where you have a new product or a new design, you have to speak about its benefits and how it fits in.

MR. ROTH: Other questions?

MR. KEVIN J. HOWARD: I want to followup with John Hele on that. Does that mean that the prospectus would be able to have current performance shown?

MR. HELE: I really have no idea where the NAIC is going on it. The SEC rules currently allow historical performance with funds. If you have a new product coming out today, you could have fund records that have been around for ten years. You could show an historical performance, even though the product was not available ten years ago. And that is what the SEC and the NASD allow.

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I do not know what the NAIC is going to allow. They have not even addressed variable products yet.

MR. ROTH: I guess the question I have about the NAIC action here is what effect it is going to have on the hypothetical restrictions that are currently moving forward. The SEC does allow projecting forward on both a guaranteed charge basis and the current charge basis. If I understood you, the NAIC proposal would not allow some of that.

MR. FENTON: Other questions?

MR. MARK A. MILTON: I have been following for some time, with great interest, sales statistics and the VALUE survey. I have two questions. The first is, is anyone tracking the percentage of those sales that are replacements? And second, are any companies aggressively pursuing replacements as an offensive tactic of their own business and other?

MR. FENTON: In terms of the VALUE survey, Tillinghast has not tracked replacements. I would be interested in hearing from any companies who have been active in the market, either if they have looked at that, or if they have any thoughts in terms of how much is replacement. Any brave souls here?

No comments. I would venture to say there are obviously some replacements going on. It is probably more than 5% of sales, but less than 50% of sales; it's somewhere in that wide range.

MR. THOMAS P. MCARDLE: This question is for John. I am curious about what the administrative expenses are actually running on these products and whether companies are putting in more optimistic costs than they should be. Would you comment on that please?

MR. FENTON: Well, of course, administrative loads should not exceed costs; there is no profit built in there.

When you are pricing a new product, it is a rare exception to price at full direct cost initially. You need to reach critical mass within several years to achieve those unit expenses. I think that those companies that have been in this business for a while have found that it continues to be an expensive business. You need to add funds, as well as ongoing printing costs. I would say it is probably difficult to administer a variable life product for less than \$50-60 per policy. I would not be surprised if many companies are above that level, particularly at this point.

I also would not be surprised if some companies are pricing beneath that at this point. Other questions or observations?

MR. LARRY J. BRUNNING: I have a question for Steve. I was wondering if you could comment on the special regulations the SEC has on a fund-to-funds approach. Specifically I'm referring to a case where you would not have to clone the actual funds back into variable products; you could actually sell the public under that approach. Please talk a little bit about the load restrictions there.

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MR. ROTH: Sure. The question relates to what SEC limitations are on fund to funds. As you know, the tax law requires that the investments underlying a variable product be adequately diversified, as well as meet the specific five investment test. If you are just investing in a public mutual fund, the IRS will not allow you to look through that public mutual fund down to the portfolio investments in order to satisfy that five investment test.

So ordinarily public mutual funds cannot be used for variable products. But one way they might be used would be with the fund to funds where you set up a portfolio dedicated to insurance companies that would have public mutual funds inside it that would be managed.

As a general matter, the SEC's constraint on that is you cannot have more than a 1% or 1.5% sales load. I think there are one or two products out there. I do not know how actively they are being marketed, but I believe they have no more than a 1.5% sales load.

There is also a limit on the amount of shares of the fund you can hold. I forget what it is; it may be 3%. But you cannot hold anymore than 3% of the outstanding shares of the fund. So you have to find big funds for this fund to funds approach. It is a concept that you can make work, but it probably has a very limited utility; maybe it's useful in a direct-response variable annuity.

MR. FENTON: Other questions?

MR. DUBOIS: It has been mentioned that trail commissions are a good idea to improve the persistency of the products. I have several questions related to them. One, New York's regulation seems to be heading in a direction where we would be able to have a 12-basis-point trail in exchange for 1% up front. Is there a feeling that that will be enough? Additionally, given the situation that we are involved in, is the trail commission of 25 basis points on assets going to be enough to satisfy an agent who feels they have control of the funds and could move it and receive a 3% or 4% commission if they were to move it? If the trail enhances persistency, is it going to be enough for them to convince their client to stay?

MR. FENTON: Anyone have a response to that? The figure you gave on trail commissions is an 8-1 trade-off. The work that we have done in variable annuities tends to roughly show about a 5-1 or 6-1 trade-off in terms of pricing. It depends a great deal on lapse rates and your profit goals, and that sort of thing. However, that is roughly the range. There are some products out there with a 4-1 trade-off, but at 8-1, I do not think the agents are going to be interested.

MR. DUBOIS: The second question is whether paying brokers or agents 25 or maybe even 40 basis points on the assets will be enough to influence them not to move the funds. They can receive a much higher up-front commission if they are able to persuade their clients to move, so are trail commissions really a solution to the persistency problem?

MR. FENTON: I would say the question depends more on the level of the trail commission. There are some products out there with a 100-basis-point trail

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commission, which I think would be enough. On the other hand, at 12 basis points, I think it is less likely that they would not move the business, but I think this varies by distributor. Many of the distributors are stockbrokers, who are used to ongoing activity in the client's accounts. They want the revenue and can find ways to convince themselves and their customers that it is in their best interest to move. I think they will be less likely to do so if there is a reasonable level of trail commission.

A question for Steve. We had talked about persistency just now and earlier about internal replacements. I was under the impression that the SEC did not look favorably upon reinstating surrender charge through an internal exchange. And I just wanted to hear your response to that.

MR. ROTH: I think that that is something that they have under study at this point. I am aware of some discussions that some companies are having with the staff on that.

As a general matter, they do strictly regulate exchanges. If you want to exchange one variable product for another, then you cannot assess any back-end load on the old product. You have to treat the new product as if it had been in effect when the old product was issued. If it was viewed as an exchange, it would probably prohibit the kind of reloading you are referring to. So the legal issue is, is that really an exchange or something legitimate that is going on that can be compensated for? I do not think the SEC staff members have closed minds on that.