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CORPORATE-OWNED LIFE INSURANCE (COLI)

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This session will educate actuaries on the usage, sales methods, and design of COLI products and the many variations. Presenters will discuss market potential, distribution systems, product features, pricing implications, and tax issues.

MR. STEVEN A. EISENBERG: We have a distinguished panel. I will briefly introduce them. Judy Faucett is with Coopers & Lybrand. Tim Millwood is with Milliman & Robertson. Jack Coleman is with Sun Life of Canada in Boston and will be our recorder.

The first speaker is John Ryan. John is a vice president with Metropolitan Life and is in charge of the specialized benefit resource group—basically the unit that controls all the COLI business. He has been involved with the public COLI market for more than 25 years, through various positions in Metropolitan's personal and group insurance operations. In 1987, John started a separate COLI operation at Metropolitan Life and pioneered the use of fee-based products in the large corporate marketplace. He received his B.A. degree in modern languages from Brooklyn College, and his M.B.A. degree in finance from Long Island University. John will talk about the market as he sees it from Met's perspective.

MR. JOHN RYAN: I hope to give you one carrier's perspective on what we refer to as the COLI market. The context of my remarks will be in the public corporation marketplace. There are some differences between the closed corporation and public corporation markets but, in general, all the principles apply.

A long time ago, back in the late 1960s and early 1970s, COLI involved, very simply, the corporate purchase of several whole-life policies on executives to finance non-qualified pension benefits. They were called supplemental executive retirement programs (SERPs). The products were off-the-shelf retail products, and as things went along into the early 1970s, there usually was an agreement between the carrier and the producer to trade commissions for some type of liberalized underwriting. Over the years, a small handful of entrepreneurial brokers, working with a smaller number of carriers, raised the level of COLI product development and marketing to an art. The products became differentiated. Sophisticated marketing support software was developed. Carriers for the first time, probably in the mid-1970s, began to view COLI as a distinct class of business for marketing as well as financial purposes.

Two tax law changes, one in 1984 and one in 1986, dealt with the taxation of group term life insurance to employees and the corporate deduction for interest on life

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*Mr. Ryan, not a member of the sponsoring organizations, is Vice President of Metropolitan Life in Iselin, NJ.

insurance policy loans, respectively. These two events were landmark occasions for the COLI market. They revitalized the use of split-dollar and so-called Section 162 bonus programs. They gave rise to a new form of COLI, sometimes referred to as broad-based leveraged COLI, or the form of COLI that is now the subject of two different bills floating around in Congress.

Of course, all during the 1980s and on a continuing basis, other federal tax law, accounting, and SEC rule changes influenced the COLI marketplace. The entrepreneurial brokers are still a major force in the COLI market, but there are now an increasing number of new COLI applications. The buyer community, primarily as the result of increasing involvement on the part of the consultants, has become much more sophisticated.

The COLI landscape includes split-dollar, in all its forms and variations, and Section 162 bonus plans, which are basically individuals owning a permanent life insurance policies outright and the employer paying a premium on a taxable basis. There is trust-owned life insurance and bank-owned life insurance. Of course, there's nonleveraged and leveraged COLI. One or more of these product applications or programs are used as alternatives to group term life insurance for executives to finance and/or secure nonqualified executive pension benefits, to finance or fund retiree welfare benefit liabilities, and to finance various benefit liabilities for corporate directors. The way it looks right now, the broad-based leveraged COLI application will be sharply curtailed, or even eliminated, by virtue of the tax law, if something passes this year. But, the market for nonleveraged COLI programs is very likely to remain viable and substantial.

Does this mean that any life insurance company can take a permanent life insurance product, put on a few bells and whistles, and increase sales and earnings in the COLI marketplace? Not quite. There should be no doubt whatsoever that COLI is a highly specialized market. In our view, two fundamental factors must be present if a carrier has even an opportunity for success. The first factor needed is a commitment from the very top—a long-term commitment. The second point needed is fully dedicated resources. COLI sales can take one or two years to close and involve a long-term relationship in which high-quality, responsive service is an absolute key. If the commitment on the part of the carrier, from the top down, is not solid and for the long term, then success is unlikely. Underwriting, marketing support systems, product administration systems, and policyholder service operations need to be dedicated to COLI applications. What has evolved during the past 20 years or so is that COLI operations grew out of retail insurance operations, and in some places, they're still very much intertwined with retail operations. Over a long time period, that does not create the best scenario for profitability.

In addition to the basic prerequisites, the next critical step, from a carrier perspective, is determining who the primary customer is. If the primary customer is the broker, it's likely that product design, marketing support, and administrative support will be distribution-driven. In some cases, carrier profitability can be distribution-driven. If the primary customer is the end buyer, these processes will be mostly carrier-driven. In that case, it is even more essential that the carrier have the marketing and technical skills at least equal to those on the outside and have the ability to deal, at top levels, directly with clients.

Regardless of who the primary customer is, a carrier, from the very outset, must be prepared to make a major commitment to servicing COLI programs. Some would say that this is the area that distinguishes the specialty brokers who are involved in the COLI market; that is their forte and that's why they get paid the big bucks. But any carrier in the market, or any carrier thinking of going into the market, or trying, needs to recognize from day one that the carrier will probably outlast the broker. At some point, sometime, the responsibility for servicing the plan will fall back on the carrier. Plan servicing is not policyholder service. It involves keeping abreast of tax and insurance law developments as they affect the employer and the insured employees; monitoring accounting, SEC, Office of the Comptroller of Currency, and other governmental agency rules and regulations; providing ERISA reporting where appropriate; providing periodic reports that tie into corporate financial statements; maintaining all plan documents and suggesting revisions to keep them current; and providing periodic actuarial valuations.

Some might say that an in-force illustration system is the most important element in servicing COLI programs. In our experience, that is just the starting point. A comprehensive financial modeling system with an integrated in-force illustration capability is necessary. Valuation and sensitivity analysis are the objectives. For many aspects of today's deferred compensation market, a big part of which consists of voluntary executive deferral programs, 401(k)-type administration is becoming a necessity. Bottom line, if the carrier is in these markets, it will, at some point, have to have these capabilities in addition to other necessary elements for the COLI market. Those include market segmentation and product mix. No one carrier can be all things to all people, but the tax sensitivity of COLI products warrants a balanced involvement in more than one subsegment of the market. For example, a carrier with a heavy concentration in bank-owned life insurance is probably more vulnerable to future legislative or regulatory change than a carrier that spreads its COLI business among bank-owned life insurance, split-dollar, and deferred compensation.

Pricing is another critical factor, because it is much more dynamic than might be the case for retail products. It would probably be best to precede any discussion of pricing with some of the trends that are happening in the marketplace, in terms of product structure and design. The most prominent trends we see are a substantial increase in the use of separate account products across all subsegments of the COLI market; an increase in the use of the group product form as opposed to the individual form, particularly in the larger cases; many more low- or no-commission products; and, many more open-box design products, as opposed to black-box-type designs. All these factors result in increased pressure on the carrier and the producer margins. In this environment, the incidence of pricing on a case-by-case basis increases in proportion to the size of the case. In all cases, it's important to keep in mind the long-term nature of COLI transactions and set standards that result in fair treatment to all parties. If the deal isn't good for everyone, then somebody is going to end up unhappy and the relationship won't last.

With this in mind, we've set some objectives for our continuing presence in the COLI marketplace. The buyer is our end customer. As such, we are set up to deal directly with the buyer on a fee-for-service basis. We very much value specialty broker relationships and view the broker as our long-term partner in addressing the client's continuing needs. We have set underwriting standards, both in terms of the rate basis and the mortality charges applicable to predefined case parameters. This means we have the right level of guaranteed issue limits and the flexibility to mix guaranteed issue rates, simplified issue rates, and fully underwritten rates either in the same case or even on the same life, where appropriate. That makes illustrations fun and is why we do that. Mortality or risk charges, whether in group or individual products, need to be based on solid data relating specifically to the experience of executives in noncontributory life insurance programs in the large corporate marketplace. For experience-rated situations, we work with the employer and its consultant to set the right level of risk charges. This is particularly important when the group form is used. You must make sure there's a sufficient level of risk to maintain qualification of the policy as life insurance, not under Section 7702, but under Section 101.

For general account products, we believe it's important to limit situations in which one buyer has control over a large amount of the carrier's assets. We have turned down cases involving $30, $40, and $50 million of annual premium in general account products because the assets build up to very substantial amounts, sometimes as much as half a billion dollars over a ten-year period. We could have contracts in which one owner has the ability to come in at any time and say, I want all the money today at book value. That's not good for anyone. It's certainly not good for the carrier, and it's not for the buyer either. Because if a carrier were to do that for one buyer, it likely would do it for others. Even the buyers who may not surrender could be harmed by those who do, so it's something we've tried to stay away from. We've also sought to internally segregate general account COLI assets to optimize asset/liability matching and achieve the best possible investment results with the right type and quality of assets.

In closing, I'd like to go over some of the general risks associated with the COLI business. Certainly, the rewards can be high. If everything is done right, costs are minimized. With regard to multilife plans with high amounts of coverage on individual lives and relatively high amounts of guaranteed issue on all lives, it's sometimes a good idea to take a look at what reinsurance can do to stabilize the book and spread potential catastrophic losses. It seems that, on an increasing basis, and in larger cases, today's carriers are being asked to provide financial guarantees that may not necessarily be related to the product. For example, will the carrier guarantee that the employer has an insurable interest in all of its employees in all states? That's not an easy thing to do. If a carrier does that, what's the financial exposure? If two or three of these things are done, they must be done with extreme care because the results could be disastrous. This is not a case in which something prospectively might change.

In our view, the real risk in leveraged COLI is not the interest deduction; it's that somebody might question the employer's insurable interest. With 15,000 or 20,000 lives, where there is $3, $4, or $5 billion of death benefit exposure, most of which already may have been paid when a question comes about, there could be a major financial risk. The integrity of our products requires us as carriers sometimes to say no, even in the face of the occasional megadeal. Situations where this might be appropriate are in the use of unregistered variable life products in which the buyer or corporate owner wishes to control all the investments and in certain applications of split-dollar programs today where they are used in conjunction with nonqualified deferred compensation plans, particularly voluntary deferrals. These are areas that the Treasury and the SEC currently have under consideration. Our experience on the leveraged COLI side demonstrates that if there is a perception (perception is the key word) that we, the industry, are pushing the envelope and that the envelope will be sealed. We hope the carriers, working together with the consulting community and the brokers, can take a proactive stance going forward in designing the rules, or in effect, designing the envelope, so that we don't have to be reactive in the future.

MR. EISENBERG: Our next speaker works in Atlanta, GA. He happens to be my associate, Tim Millwood. Tim has been designing COLI products for about eight years and has experience with all types of COLI products. Tim will talk about product design.

MR. TIMOTHY SIMON MILLWOOD: John may have already covered some of the things I was going to go over in my presentation. I was briefly going to cover the types of sales I see in the COLI marketplace, move on to the kinds of products that are used, then spend a fair amount of time on actuarial assumptions, and follow that up with a few simple examples.

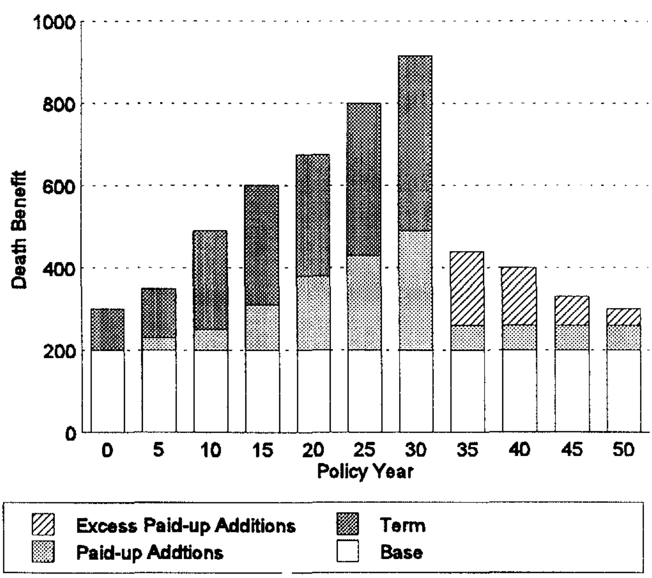
I like to separate the COLI marketplace into three categories. The first category would be what I consider to be cash-value-driven COLI sales, such as SERP, deferrals, and 401(k) overlay plans. These are plans with a large amount of cash value built up to fund certain cash retirement benefits. The next COLI type of plan would be the death-benefit-driven COLI plans, and examples would be the Section 162 bonus and the death-benefit-only plans. These plans have relatively high death benefits and smaller cash-value requirements. I look at them as being a different marketplace from the cash-value-driven products. Finally, the specialty COLI plans would be things such as leveraged COLI, BOLI, and the postretirement *Financial Accounting Standard (FAS) 106* funding plans. There aren't many players in the specialty COLI marketplace.

I'll move ahead to products. As John said, historically, the products used in the COLI marketplace were participating whole-life contracts, probably with paid-up addition riders and, with the introduction of 7702A, term riders. There's also the nonparticipating equivalent that uses credits instead of dividends. I don't know whether people are familiar with those, but they look a great deal similar to participating plans. More recently, companies have moved on to the fixed and flexible premium universal life (UL) and variable UL contracts with term riders.

Products in the COLI marketplace need to be very flexible. One way to achieve flexibility with whole life is through the allocation of premium between base plan premium, paid-up addition premium, and term rider premium. You also have a choice on how to allocate the dividends. You can pay those out in cash, add them to paid-up-addition, buy term insurance with them, or you can use them to vanish the premium. You can access paid-up additions cash values, you can surrender those to cover cash requirements, and you can also use them to vanish premiums. Finally, the only real way to access base policy values with a true whole-life plan is through policy loans, but you do have some flexibility there. Almost universally, all the whole-life plans I've ever seen have been cash-value-tested for Section 7702. The cash-value-tested plans allow you to generate a large amount of cash early on, but these plans seem to be at a disadvantage for long-term accumulation sales because they have larger corridors than guideline premium test plans. Also, historically, the participating whole-life plans have used portfolio dividend-credited rates. I haven't seen too many new money products out there. As with any type of whole-life plan, they all have a minimum fixed premium.

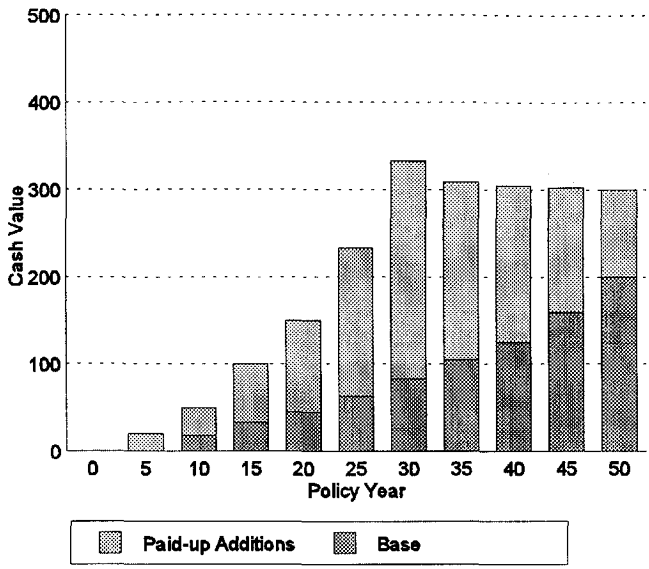
I'll try to illustrate how a whole-life plan works in the COLI sale. Chart 1 shows the death benefit pattern for a split-dollar plan. There's initially a three-times-salary plan with a return of employer premium. The death benefit requirement will go up during the accumulation years of the split-dollar plan as the salary goes up and as the return-of-premium piece gets larger. With a whole-life plan, you typically would have an underlying level of base policy death benefit, which is the lower section there. Then you need to fill in the rest of the death benefit requirement with either paid-up additions or term. Normally you would buy paid-up additions first and then figure out how much term insurance you need to buy to fill in the difference. For this particular split-dollar plan, I assumed rollout at the end of 30 years. Sometimes with whole-life plans you're actually forced to buy more death benefit than you need. The excess paid-up additions represent extra death benefit that we didn't need for this particular COLI plan. It was caused by having too much paid-up addition, and for this particular example, there was no way to get rid of that. We didn't need any term insurance, and we had a larger paid-up addition death benefit than was required. I'll talk about that later.

CHART 1
WHOLE LIFE—COMPONENTS OF DEATH BENEFIT



Moving on to the cash value components for a whole-life plan (Chart 2), you essentially have an underlying base policy cash value that starts at zero and grows to the ultimate level of the base policy death benefit. Then you have additional cash values from the paid-up additions.

CHART 2
WHOLE LIFE—COMPONENTS OF CASH VALUE



Finally, there is the allocation of the premium. Chart 3 shows the flexibility of the product. There'll be an underlying minimum base policy premium, which is the lower section. Then, within the COLI plan, you need to somehow allocate the rest of the premium between paid-up additions and term so that you buy the required amount of death benefit and complete the funding. Also, for this particular whole-life plan, I assumed vanished premium at the end of 30 years. Even though the premium vanished, you still technically have to pay the premium with a whole-life plan, and I was using surrenders of paid-up additions to pay that premium, which made it look like it vanished.

Next we will move ahead to UL which, by its very nature, is flexible. You have your choice of premium levels, the amount of the premium, when you pay it or when you don't pay it. The base policy death benefit on UL can really be changed at will. You can add a term rider to add even more death benefit flexibilities. You can access policy values through either partial withdrawals or policy loans. The more recent generation of COLI UL allows the policyholders the choice at issue of using either the cash value test or the guideline premium test, which gives them a little more flexibility. I like the UL design because I think it's easier to explain to the buyer. It's more of an open-box design than John's black-box design. Of course, with variable UL, you have the choice of investments.

CHART 3
WHOLE LIFE—COMPONENTS OF PREMIUM

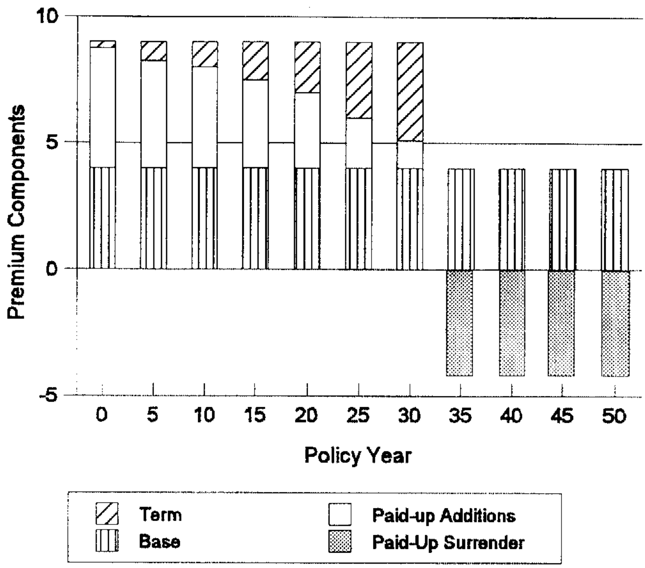
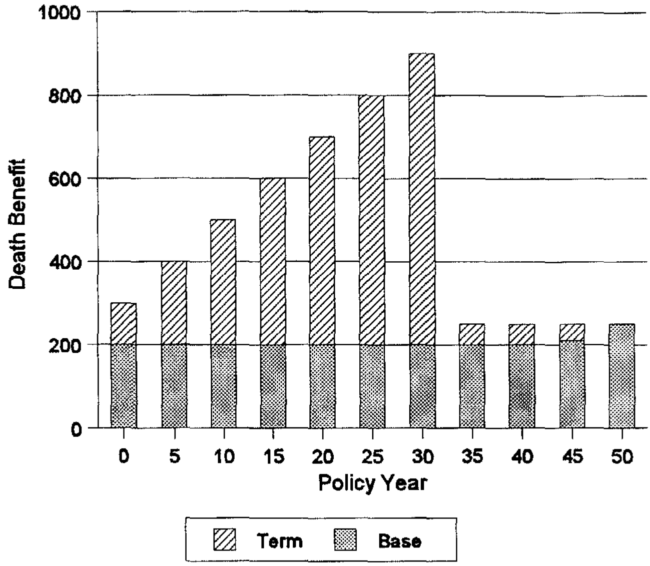


Chart 4 shows the same split-dollar plan that I showed on the whole-life example. You can see the death benefit. Generally, with a UL contract you'll issue a base level of death benefit that'll stay level. Here it increases slightly right at the end because the cash value increases above the death benefit level in the 7702 corridor so it has forced that base death benefit up. You then just fill in the rest of the death benefit requirement with term. In this particular case, you're not forced to overbuy death benefit as you were with the whole-life plan.

The question is, which product's best for COLI? I think people generally believe that UL is a more efficient COLI product, generally because they are not forced to overbuy a death benefit. I think that fundamentally the fact that UL has one cash value and whole life has both a base cash value and a paid-up-addition cash value means that the whole life doesn't have the same kind of flexibility that they have with UL. Also, the fact that they can't really do partial withdrawals on a true whole-life plan from the base cash values make it slightly less flexible. Having said that, a large proportion of the COLI producers believe that whole life is better. I think one of the reasons for that is historically they've looked at a gross dividend scale and compared it with a UL net credited rate. Many times they're looking at a mutual company's old policy portfolio rate, which is much better than a company's new UL net credited rate, so they see a much better interest rate with the participating plans. Also, in general, the commissions tend to be a little higher on the participating plans. The New York limits are perhaps a little more friendly toward whole life. They let you pay commissions on vanished premiums. With UL, if there's no premium, there's no commission. What always surprises me is that it's believed that mutual companies offer insurance at cost.

CHART 4
UNIVERSAL LIFE/VARIABLE UNIVERSAL LIFE
COMPONENTS OF DEATH BENEFIT

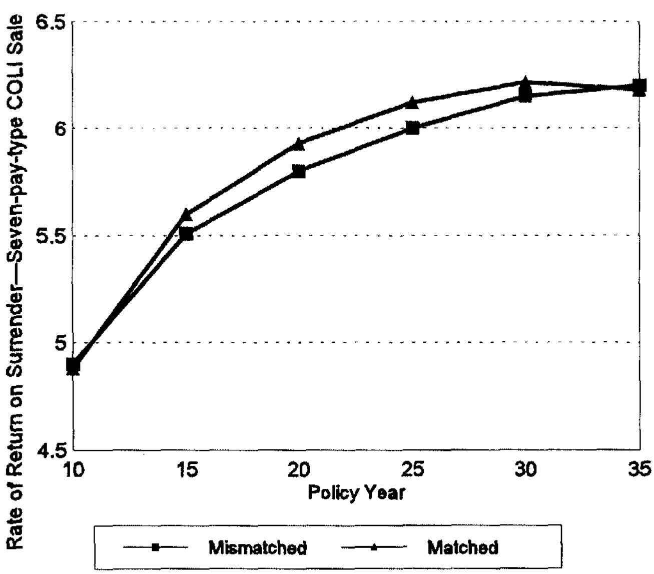


Product features that you would need in a COLI product are obviously premium and benefit flexibility to allow the informal funding of the COLI plans. Producers these days will require commission flexibility. Many people call it dial-a-commission, and that needs to be in the product. There needs to be a way that a broker can give up a dollar of commission and put it into a dollar of policyholder value. Most modern-day COLI designs accomplish that fairly well. The other item is whether the product is matched. I believe strongly that COLI products should be matched, and I'll talk about that a little bit later. As far as some benchmarks as to what makes a good COLI product, I like to see my ratio of first-year cash value plus commissions to premiums in the 100–110% range for a fairly high-funded sale. As I said before, the product should have the ability to convert commission to cash value. That means the broker is able to show the buyer a first-year cash value in excess of premium in some situations. Also, the rate of return on surrender or death over 30 or 40 years probably needs to be something like the net credited rate less 60–100 points. It could be a death-at-80 example or it could be partial mortality. For things such as carve-out plans, the focus tends to be on premium levels, and so you can't tell relatively how good your product is without looking at competitive values. These two methods, the first-year ratio and the net reduction to the credited rate, allow you to look at how good your product is versus itself.

When I talk about matched or mismatched products, to me, a matched product is where product loads cover the related product expenses plus a small profit margin. An example of this would be in a UL contract in which you would set your cost of insurance rates equal to mortality, plus a small mortality profit. That makes a great deal of sense, and that actually ties in with the new illustration regulations. You have to remember that the COLI marketplace has sophisticated buyers and, if you're using a COLI broker, it generally has sophisticated sellers. If you have a mismatched product, either directly or indirectly, those people will exploit that mismatched design, and it will generally be at the expense of the insurance company. The other reason I like the matched design is because it's very easy to explain to buyers. It's easy to tell them, "I'm going to charge you all my costs plus a small profit margin." They may disagree with your costs, they may not like the profit margin, but at least they understand what they're buying. Often, to many buyers, COLI is a complete mystery.

Chart 5 is an extreme example that was put together to illustrate why a mismatched product is dangerous. In this particular situation, I designed a matched contract for a seven-pay accumulation sale. The matched line shows the rate of return on surrender to the policyholder for different durations. I took that same product and eliminated the cost of insurance charges and decreased the credited rate by 80 basis points. That was essentially equivalent to the cost of insurance charges. The rate of return on surrender to the buyer doesn't really change, and the insurance company profits were similar for this sale.

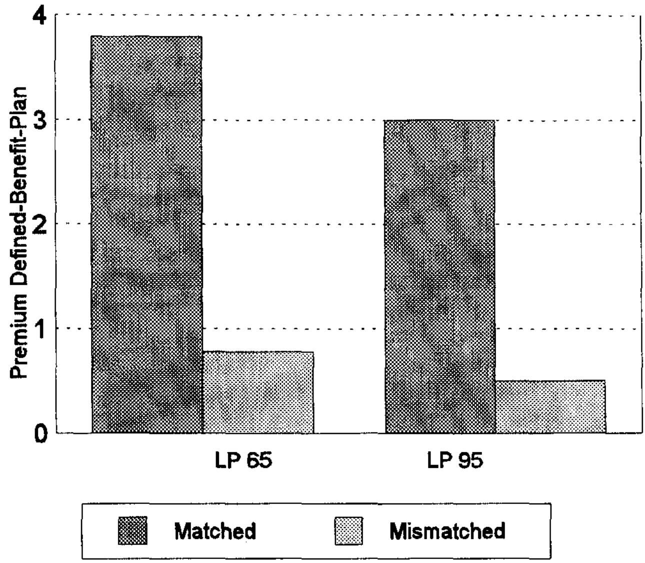
CHART 5
PRODUCT PERFORMANCE—MATCHED VERSUS MISMATCHED



Note: Mismatched designed for seven-pay accumulation. Uses additional 80-basis-point spread instead of cost of insurance.

I'll move ahead and use the matched-versus-mismatched product in a death-benefit-driven sale such as carve-out. The taller bars represent the matched premiums on Chart 6. Those are the minimum premiums you need to charge to cover your expenses and make a profit. With the mismatched product, the premiums are a quarter of the level they need to be. This was an extreme example in which I replaced cost of insurance (COI) with interest spread. Anytime you have some kind of offsetting charges, one thing against another, and you design for a certain COLI sale, you're likely to get selected against by the COLI brokers so be careful of mismatched products.

CHART 6
PRODUCT PERFORMANCE—MATCHED VERSUS MISMATCHED



Note: Mismatched designed for 7-pay accumulation. Uses additional 80-basis-point-spread instead of cost of insurance.

I'll now move on to actuarial assumptions. Probably the things companies talk to us about the most are mortality issues. You generally see some COLI plans use underwritten mortality, and that may be medically underwritten or simplified. Mortality for those plans is typically similar to high-end individual mortality. The item that causes more concern to most companies that don't have experience is guaranteed issue. Guaranteed issue in the COLI marketplace does not mean no underwriting. With guaranteed issue, there's almost always an actively-at-work requirement for the past several months. You also need to do group underwriting. You need to underwrite the COLI plan. You need to make sure the COLI plan makes sense. You need to make sure that a certain level of executives are covered. You want to make sure there's no individual selection of amounts. You want to underwrite the company. Is the company stable? How big is the company? Who's the decision maker? You want to underwrite the person selling the business for you. Has he or she given you good business before? What's his or her track record? Generally, you'll always want 100% participation for these plans. You have to remember that with COLI there will be future increases in the death benefit. Most COLI producers these days require that those future increases be preunderwritten, or underwritten at issue. Even though the plan may start off with $300,000 of death benefit, it may rise to $700,000 or $800,000 and you need to take that into account when you do your underwriting.

The last thing to think about is that some of the COLI plans, even though COLI is corporate-owned, are only corporate-sponsored. Split-dollar plans are generally employee-owned. After the employer's interest has been rolled out, you have essentially many individual contracts owned by employees. They get to decide whether they keep those contracts. For some COLI plans, there's possibly antiselection around the retirement age when people are deciding individually whether they'd keep an insurance policy in force or take the cash value. The last item I advise against would be using mortality improvements. I would say, almost universally in the COLI marketplace, nobody uses mortality improvements anymore, though I do know of one or two companies that still do.

With guaranteed issue, one of the questions that comes up is, I want to enter the COLI marketplace and I don't have any guaranteed issue experience. What do I use as a mortality assumption? We would generally recommend to people two possible ways of developing guaranteed issue. One would be to take your medical assumptions that presumably you feel fairly comfortable with and apply multiples to those. A typical multiple for guaranteed issue might be to use 150–200% of your medical mortality initially and grade that down to somewhere between 90% and 110% by the ultimate years. Or you could just take a percentage of your ultimate mortality—somewhere between the 90–110% range. The reason I say you may want to use less than 100% of ultimate mortality is that with individual business you generally have higher lapse rates than the COLI plan. To a large extent, many lapses that occur on an individual plan are the antiselective mortality lapses. Somebody who is heathy will lapse his or her plan. Somebody who is unhealthy who is thinking about lapsing his or her insurance probably won't. With COLI, you don't really get those individual decisions, you don't really get lapses related to mortality. They're related to other issues and so you could argue that the ultimate mortality for COLI will be better than the ultimate mortality for individual, although that's a tough sell to some companies.

Then as John pointed out for the larger cases, and the definition of larger case is coming down but is probably in the 1,000–2,000-life range, cases want to be experience-rated. Even cases issued on individual policy forms want to do individual experience rating, which is still a novel concept to me, but that's what they require. They accomplish that by setting up a mortality fluctuation reserve for the case and then going forward they will adjust future loads, dividends, or cost of insurance rates to adjust for actual mortality experience as it differs from expected. One of the big questions I have for the companies that do this is I don't know whether they allocate the mortality fluctuation reserve back at the individual policy level, but if they do, do they consider that for 7702 purposes? It's kind of a gray area, and I'm not sure it has been fully defined yet. As John said, it's much easier to do this if you use a group form.

When it comes to lapses, one difference between COLI and regular individual business is you have to worry about both individual lapses as well as case lapses. Individual lapses are not that common in COLI. They probably result from individual employee turnover. In many COLI plans, even if an employee leaves the company, the insurance is still kept in force. The bigger issue is a case lapse. I mean, as John said, you could have a very large case, and one decision maker could decide "I don't like this plan anymore. I'm going to lapse this plan." You could lose a couple $1,000 policies. One thing you should always look at with the COLI plan you're placing is whether there's a single or multiple decision maker. Arguably, with some of the split-dollar plans that are employee-owned, it's harder to have a case lapse because you're going to have to convince many employees to do it. There may be a single decision maker in a big corporation, but it may have to go through a committee, and possibly the experience would be a little more stable. In general, I think we've found that COLI cases seem to have very good persistency. Lapse rates are probably in the 2–4% range annually. Some brokers have even better experience.

As I mentioned on the mortality side, if you get to one of the COLI plans in which individual employees are making decisions at retirement, you could have an increase in lapse rates at that point. You have to remember that COLI is a rating-sensitive business. You're selling to sophisticated buyers. If your company is not willing to manage ratings to a certain level and lets ratings slide or there's a downward trend, the business is probably going to leave. You have to understand that up front. If a company wants to be a COLI player, it needs to keep its ratings up, and some companies have overlooked that. Another way to minimize the impact of lapses is to not take much strain on the product. The less strain there is, the less the impact of lapses. The other issue you need to be concerned about with the COLI plans is that many plans won't necessarily lapse. The participants will do a 1035 exchange to somebody else if they're not happy with you.

On the interest side you always have the decision of whether to use new money or portfolio. As I said, historically, companies have chosen the portfolio rate because portfolio rates have been ahead of new money rates. The big question in my mind is what happens when new money rates are 200 or 300 basis points ahead of portfolio rates? There could be many 1035 exchanges at that point. Companies seem to be fairly conservative in their COLI investments. They're probably investing out three to five years as far as duration of assets. In addition to guaranteed issue, the other big question we hear is, what do we do about the C-3 risk with these book-value products? Unfortunately, we don't have an answer to that. We tell people that if they want to write this kind of business, they have to be comfortable with the COLI plan. If they don't understand the COLI plan and they don't trust the producers, or they don't like the companies they are doing business with, they shouldn't be in this marketplace. That's not a great answer, but it's the only real one we have. We tell companies that can't buy off on that as an answer to issue variable contracts. They get rid of the C-3 risk that way. But if they do offer the variable contract, they should be very careful about whether they offer a general account option. If they have the general account option in there, they still have a lot of the C-3 risk they had with the book-value products.

On the expense side, it's important to distinguish between policy administrative expenses and plan administrative expenses. We generally tell companies that it's OK to do the policy administration, but the COLI producer should do the plan administration. It can be potentially very expensive to do good plan administration. One way to get the broker to do more plan administration is to make some of the commission a service fee. If he or she doesn't do the service, reassign that service fee to somebody who can do the plan administration. COLI products in general are very competitive. A company that has major overhead problems will find that COLI is not the answer. You can't add a large amount of overhead loading to your COLI product and have it be competitive. Another big decision within companies is whether they do the administration internally or go outside. Many companies are not set up for COLI administration. They need to do both individual policy administration as well as case level administration and reporting. By the time they go through all the layers of computer people, it will cost $3 or $4 million to complete the system module.

Several very good TPAs can do it for probably less than you can do it internally. It's a tough decision for some companies but, you know, money talks. As John said, one of the things that's often overlooked is, you must have illustrations for COLI, but you also need to have reillustration capabilities. I've seen companies do this two ways—some companies try and build reillustration capabilities into their administration system, which to me is incredibly complex while other companies go the route of taking a feed from the administration system and feeding it into a COLI illustration system, which then becomes the reillustration system. Some companies have tried to do that internally, and some good outside illustration systems are able to do that.

The last two issues are expense issues and premium tax. The majority of companies probably pay premium tax based on the state of residence of the employees, but some still use billing state, and that becomes an issue in some of the bigger COLI cases in which a small percentage of premium can make a big difference to policy performance. As for deferred acquisition cost (DAC) tax, I'd say the majority of companies probably finance DAC at their regular insurance company rate of return. Some companies use a lower rate, such as 8% or 10%, recognizing that DAC is not really an insurance company risk.

Other considerations with COLI are that there's always the possibility of a tax law change. Something such as a flat tax, which would essentially level the playing field between insurance and other investments, would certainly make COLI less attractive. As John said, there's talk now about eliminating deductibility of loan interest, which would essentially kill off leveraged COLI. There's always the possibility of inside buildup being taxed, death benefits over basis being taxed, or just basis being redefined to include some component for cost of insurance. All those things would hurt COLI plans. Another issue is that these are sophisticated buyers. If they don't think you're delivering on what they thought they were going to get, they certainly have the resources to take legal action against you. Even though they may not prevail, you would still incur substantial legal bills defending yourself. Finally, you want to make sure that you don't get stuck with plan administration, or if you are going to do the plan administration, then make sure you price your product to cover that cost.

As for profit targets, I'd say the majority of companies we deal with price by using a return-on-capital basis. One of the questions is what level of capital to use. I'd say most companies are probably using a multiple of risk-based capital—somewhere in the 150–200% range. Some companies still persist in using their own internal formulas. One of the big issues with COLI is, for either leveraged COLI or some of the private placement variable contracts, what capital do you use for loans or the separate account? Risk-based capital formulas don't require that you set up anything up for those components. But then you get a very competitive product that gives you, say, your 15% rate of return, but it produces very few dollars of profit and you get to the point of saying, why would I even be in this business?

The other thing you have to decide when measuring return on capital is, are you calculating on an ongoing or terminating basis? The difference is that on a terminating basis you assume you get your capital back at the point of calculation. It doesn't make much difference if you're measuring over 30 years, but if you're trying to get a return over ten years, it's almost impossible to do on an ongoing basis. The next decision is how much strain to take on the product. Ideally, you'd like to take no strain, but the reality of the marketplace is that you probably need to take somewhere between 5% and 20% of first-year premium to give you that 100–110% first-year ratio of cash value plus commission to premium. Having said that, you would still like to break even early, and people probably target a break-even year at somewhere in the two- to five-year range, assuming you get your DAC amortization back.

To illustrate some of these points, I put together a sample product. We will often do this, just to benchmark a COLI product, to see how good it looks. With this particular sample product, I assume I want to make a 15% return on capital. The assumption is that I could earn 8% pretax on passive capital. I'm in a 35% tax bracket, and I will use a capital formula of 4% of reserves, $1 per $1,000 net amount at risk, and 4% of premium. That information tells me that I need a profit loading of 60 basis points on the investment side, $0.15 per $1,000 net amount at risk, and 0.6% of premium.

I then made some assumptions as to mortality, investment, lapses, and expenses. These would be typical assumptions for a large, but not very large, COLI case, as we have a 10% first-year commission. Using those assumptions, I put together a matched UL contract, and I ended up with cost of insurance rates equal to my mortality assumption of 40% of 1980 CSO plus my mortality profit of $0.15, a net credited rate of 7.4%, some percentage of premium loads, and monthly policy fees as follows:

- 40% of 1980 CSO for mortality
- 8% net investment
- 4% per year lapse rate
- 2% for premium tax; 1/8% for deferred acquisition cost
- 2% for overhead (year 1 only)
  10% (year 1), 5.0% (year 2+) for commissions
  $48 for issue and underwriting (year 1 only)
  $60 for administration (all years).

Once I've come up with my matched product, I'll then do some sensitivity runs. Some people like to see how they look competitively, and if it doesn't look the way they like it to be, they'll go ahead and change the assumptions. I prefer to change my profit margins. I'm thinking that, if I felt comfortable with those assumptions before I started, I should still feel good with them. It's better that I let my competitive position flow through my profit margin than anything else.

In Chart 7, the middle line is the rate of return on surrender to the policyholder for the matched product. I used two other matched products with a different capital formula. One was at the 75% level of my original capital formula, and one was 125%. You can see that there are a few basis-points of difference in the results.

CHART 7
PRODUCT PERFORMANCE COMPARISON FOR OTHER CAPITAL LEVELS
ACCUMULATION SALE

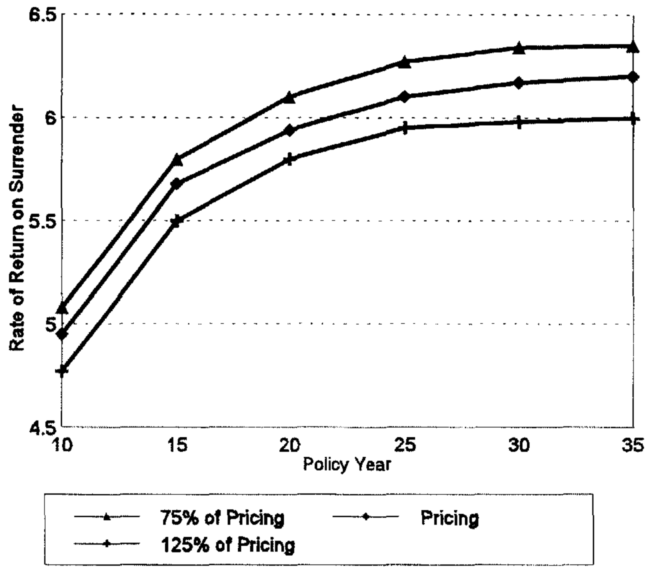


Chart 8 is intended to show how much better a separate account product can be than a fixed account product. With my separate account product (the top line), I assumed I had no capital on the separate account values and so there are a full 60 basis points of increment on policyholder return. This is where one of the issues comes in. This is a great product for the policyholder, but the profits now are so small, why would an insurance company want to offer this product?

Similarly, there would be some sensitivity on some of the assumptions. There are actually three charts here: one for a carve-out sale (Chart 9), one for a split-dollar sale (Chart 10), and one for an accumulation sale (Chart 11). Those show the sensitivity of the results to some of the assumptions. If I vary the mortality by plus or minus 25%, the premium changes for a carve-out sale by about 18%. You can see the mortality improvements. Those are 1% and 2% annual mortality improvements for 15 years so that's somewhere between the 25% reduction in mortality. Then lastly, I have an increase or decrease in my credited rate of 50 basis points. In this case, that generates about an 8% change in premium, which is a little less than half the difference for a 25% change in mortality.

CHART 8
PRODUCT PERFORMANCE—COMPARISON TO SEPARATE ACCOUNT PRODUCT
ACCUMULATION SALE

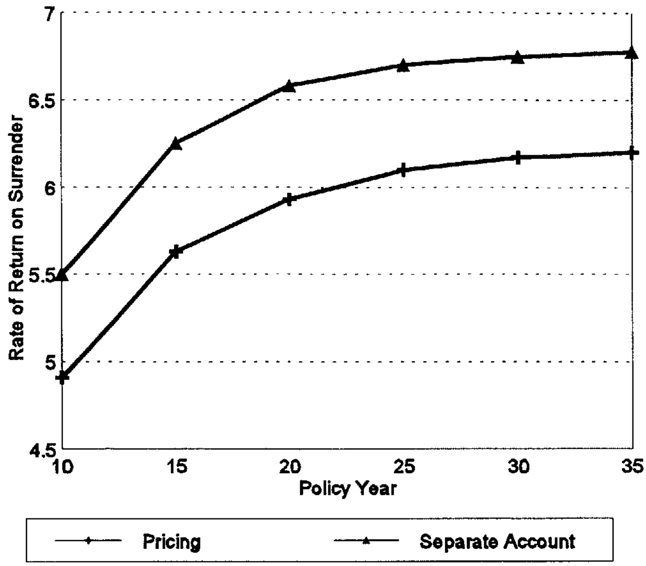


CHART 9
DIFFERENT PRICING ASSUMPTIONS—CARVE-OUT SALE
PERCENTAGE OF PRICING PREMIUM

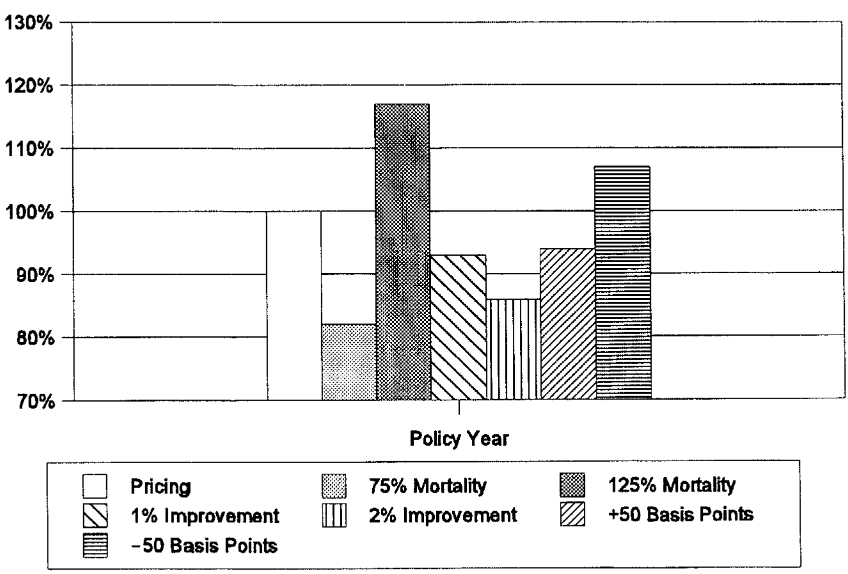
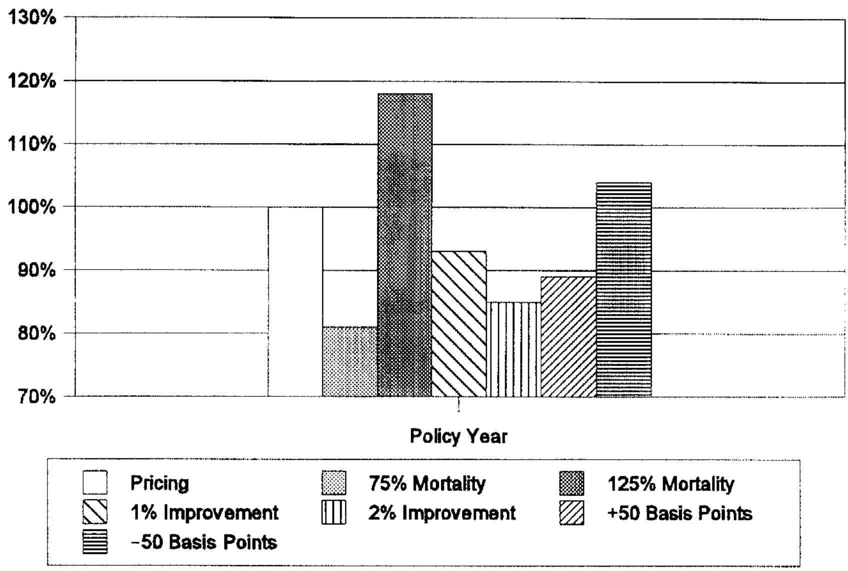


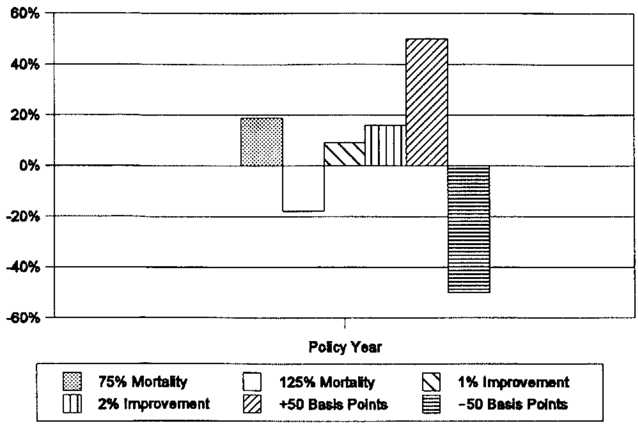
CHART 10
PRODUCT PERFORMANCE—DIFFERING PRICING ASSUMPTIONS
SPLIT-DOLLAR SALE



Moving ahead to the split-dollar plan (Chart 10), the variation in the premium for the mortality differentials is still about the same. You can see now that with the 50-basis-point change in the credited rate, the split-dollar plan is more cash-value-intensive than the carve-out plan. The difference in premium is 12% or 13% here, showing that the interest rate becomes more important in those kinds of sales.

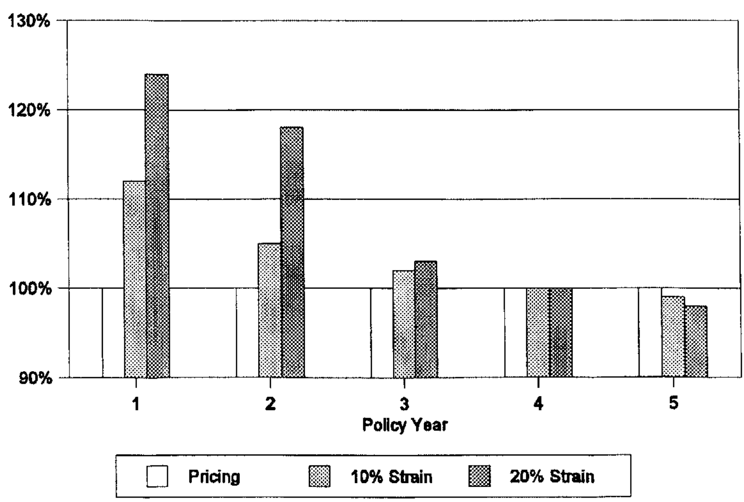
Finally, moving ahead to the accumulation sale, Chart 11 represents the basis-point reduction on the 30-year return on surrender from the pricing product. You can see that for the 25% change in mortality, there is about a 20-basis-point reduction in the policyholder return on surrender versus 50 basis points for the change in credited rate. These charts are useful if your company is competitive on the mortality side, but perhaps is not on the credited rate side, that would tend to tell you that you should be a player in the carve-out marketplace. Similarly, if your company doesn't have great mortality assumptions but has good credited rates or a good portfolio rate, then perhaps you should think about the accumulation marketplace. This may allow you to target where your product should be aimed.

CHART 11
DIFFERENT PRICING ASSUMPTIONS—ACCUMULATION SALE
YEAR 30 RATE OF RETURN DIFFERENCE FROM PRICING IN BASIS POINTS



Finally, Chart 12 shows the impact of first-year strain. The solid white bar for each year represents the pricing level of cash values for the matched product, and they're at the 100% level. The other bars are the same product, but the center bars have a 10%-of-first-year-premium strain, and that was repaid during the next five years.

CHART 12
IMPACT OF YEAR-1 STRAIN
ACCUMULATION SALE—PERCENTAGE OF PRICING CASH VALUES

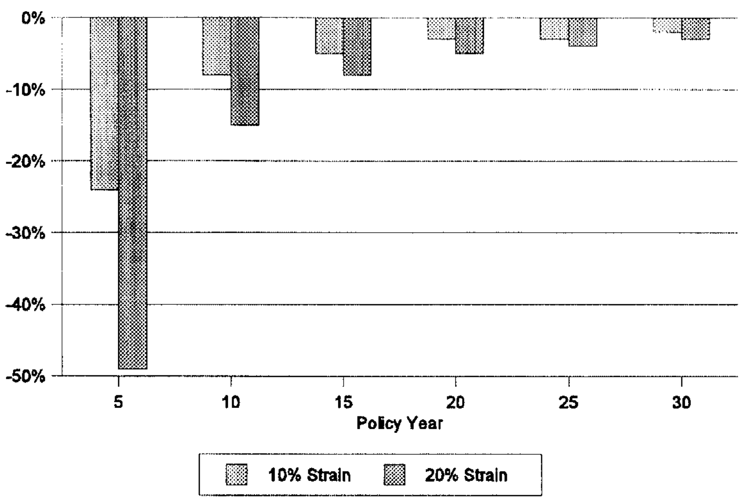


For the other one, I took a 20%-of-first-year-premium strain, and that was repaid during the five years. For the first three years, taking the strain results in the policyholder having better cash values. But by the fourth year, the three variations are about equal. By the fifth year, the product that didn't have any strain is always better.

When we move ahead several years to look at the rate of return on surrender (Chart 13), the basis point differential for the products with a strain is large initially, but it gets to be fairly small later on.

This should tell you that you generally need to take strain in the COLI marketplace. It enhances early values, it doesn't really decrease later values by more than a few basis points, and it makes the product more saleable.

CHART 13
IMPACT OF YEAR-1 STRAIN—ACCUMULATION SALE
RATE OF RETURN DIFFERENCE FROM PRICING IN BASIS POINTS



MR. EISENBERG: Our last speaker is Judy Faucett. Judy is well known to actuaries in the audience. She has more than 13 years' experience in the COLI marketplace. Judy is a principal with Coopers & Lybrand. She's also the consulting editor for the American Bar Association's primer on due care, which is really related very closely to COLI.

MS. JUDY FAUCETT: I'm here to talk about COLI from the consumer's perspective. My objectives are to help you understand the buyer's issues and concerns in designing and implementing these programs and to give you some appreciation of how the dynamics for this type of transaction will differ from a personal sale. Typically, the overarching objective is to provide nonqualified benefits to some group of employees on a basis that is both cost-efficient and tax-efficient. These benefits may include life insurance, survivorship income, and supplemental retirement income. Of late, we've seen a surge in the interest on the part of employers in nonqualified benefit plans to enhance supplemental retirement income. The rationale for this is that, a couple of years back, OBRA decreased the caps on qualified pension benefits, thus increasing the number of potential candidates for a nonqualified program. Further, the cap is linked to the CPI. So if salaries are increasing more rapidly than the CPI, this will further enhance the population that will qualify for the nonqualified program. Therefore, the employers are seeing a significant increase in the nonqualified benefit liability.

There are two choices at this point. They can either modify the expectations, that is, reduce the benefits that are going to be provided by the nonqualified program, or go through some exercise of rationally fitting the financing and cost with the design of the program to meet the employee expectation. Thus, we find that the ideal transaction starts with an analysis of compensation and benefits and an understanding of how those proposed benefits fit into the total compensation package. That defines the ideal transaction. The reality is, generally, it is still the broker who is going to the employer and explaining that there may be a problem for which there are a number of financing alternatives, one of which is corporate-owned life insurance.

In the 1970s and 1980s, these benefit programs were largely viewed as executive entitlement. After all, they were doing nothing but restoring qualified benefits to these executives. However, one of the things that we're seeing in the 1990s is that there is an objective on the part of the employer to link those benefits more to individual performance and contributions. The overall cost of the program may be consistent with benefit restoration, but the allocation of employee monies year by year to a particular individual are more directly linked to the corporate results and to the individual's impact on those results.

John and I have been working on one case that has a fairly different slant, which I think is unique in the marketplace. The starting point was that the employer was looking to rationalize group term life insurance benefits across a number of subsidiaries. That in and of itself wasn't so unique, however, within this structure they wanted to give the executives the opportunity to proactively determine how this life insurance best fit into their total financial plan, recognizing differences in needs at any point in time for capital accumulation and capital preservation. This linkage is consistent with the skills that the employer wants to see executives exhibit on the job and the rewards in its overall compensation structure. We're seeing the benefit programs start to emulate what the employer wants to see in terms of on-the-job performance. Tim and John have both talked about the interest in split-dollar plans. Certainly, the plan participants would rather have a split-dollar or a bonus plan, where they have control, security, and portability of benefits. To the employer, there are, of course, the same issues of control and cost on its side. So, depending on the overall objectives of the plan, you see them talking about bonus plans in which there is maximum executive control, possibly going to split-dollar in which there is some control by both the employer and the executive, or maybe going to the traditional corporate-owned programs, in which the employer has complete control.

I'd also like to share with you some of the buyer's views on the COLI transaction. Certainly, it is no longer quite the black box that it was in the 1970s and 1980s. The carriers and the brokers are much more open about describing how their product operates, who gets paid what, and what services are being provided. Ten years ago, the agents would do their best to characterize the compensation in a marketing transaction as being anything other than commission so they wouldn't have to disclose what the buyer might think was an egregious amount of money that they were going to earn on this transaction. Brokers appear relatively indifferent as to whether they're compensated by fees or commissions and are quite specific about the services that are included and what is available at an additional cost. The buyer has become more knowledgeable about the sensitivity of changes in interest rates and tax rates. Even if the purchase is one of variable life insurance, the buyer will still be concerned about the ratings and the financial strength of the carrier. As you heard from both John and Tim, the products are significantly focused on this market and priced specifically for it. In the 1980s, one of the things that buyers always heard was that because of the deductibility of policy loan interest, these transactions could be done at no cost. The good news is that the buyers today recognize that there is a cost to these benefit programs. The issues are, (1) How much benefit is being delivered to the executive? and (2) How much value is being added for each dollar of cost?

In addition to the basic issues of carrier strength, ratings, product, and service, I think that there are seven other points of differentiation for a carrier and a broker in this transaction. The first is an understanding of the full range of tax and accounting issues, including what could happen in the future. Buyers appreciate a candid dialogue of the issues; it enhances their trust that this is indeed a partnership, not just a sales job.

Second, they look for experience in the marketplace and a significant commitment to it. No one wants to be your first, and possibly your only, client, no matter how good your product is. These plans have specialized reporting requirements, and good long-term product performance is critical. The buyer wants assurance that both the carrier and the broker have every incentive to pay attention to product performance and client service over the duration of the plan.

Third, they're looking for creativity in plan design, product configuration, and flexibility. No plan is ever implemented according to the request for proposal (RFP) or the initial proposal from the marketer. We find that the confluence of ideas results in a better program for both the buyer and the employee. This is an area in which experienced carriers and marketers can add significant value.

Fourth is the area of communication. Most marketers are adept at explaining complex transactions in either very simple terms, or through apt analogies, as long as they don't get too simple or too apt. Here we can have complex benefit programs and complex insurance. The buyer needs help in explaining the program to the participants as well as to those who are involved in the plan approval process.

The fifth point of differentiation is the ease of installation, and this is very important. Either the insurance is being purchased to replace existing group term or to finance corporate benefits. In either case, the employer and the executives don't see this as being an issue of antiselection. They're not looking to go out and purchase large amounts of life insurance to select against the carrier. Therefore, they do not want to go through normal underwriting.

Guaranteed issue is a must, with simplified underwriting on excess amounts over the guaranteed issue limit. Often, the guaranteed issue limit is expressed as a multiple of salary with an outside limit, such as $1–2 million, depending upon the number of participants. If your are uncomfortable with the idea of $1 million of guaranteed issue, this is not the market that you want to be in.

Next on the list is reference checks. Corporate sales require more sophisticated monitoring and reporting than a personal sale. Typically, the carrier administers the life insurance and the broker administers the plan, although a few carriers have gotten into plan administration. All clients get great service during the sale. The big question is, how good is the service after the sale is made? The only way for a buyer to get a sense of that is to check with existing clients. Let me tell you, this is extremely important. To show you how bad it can be, we had a situation in which the client kept asking for in-force illustrations for some insurance policies that it had with a particular carrier. It took many phone calls over a six-month period before the client finally received those in-force illustrations of the current policies. In the meantime, though, the carrier's representative was able to send several examples of additional insurance the client could purchase to enhance the program. You can imagine how that particular buyer felt about doing business with that company, and certainly, the buyer will not be a good reference for future use.

Last but not least, there's a need to recognize that life insurance is not the cookie-cutter solution to every program—sometimes it fits and sometimes it doesn't. When it doesn't, say so, or if you're like the COLI producers I know, just convince the company to change the plan design.

Because these plans are complex, it does take longer to get to "yes" than in a personal sale; 12 months to 36 months is not unusual. A buyer may not go through all these steps but will surely cover some of them. You start with a company and benefit review, a plan design, and an analysis of financing alternatives. If life insurance is involved, there is the carrier and product due care. There's a cost benefit analysis, the internal approval process to get to "yes," and then you start to implement the program. This is clearly a longer process than the personal sale. The dynamics are also different because of the parties involved in the transaction. In a personal sale, only the agent and the buyer meet face to face. Sometimes the buyer will bring along an adviser, such as his or her tax attorney or accountant, particularly if it's an estate plan. In a corporate transaction, often the carrier is at the table. The accountants or the auditors opine on the accounting treatment. The benefit actuary looks at how it fits into the benefit program and the overall design. Last but not least a life insurance actuary may actually perform the product and carrier due care. Once all the consultants and advisors have signed off, then you go through the internal sign-off procedure, which can range anywhere from just going to human resources to going all the way to the corporate board.

Cost is also measured differently from the personal sale. In addition to the traditional measures of internal rates of return, employers will look at the annual cost, and the present value of that cost over time, the annual charge to earnings, and the present value of benefits that will be delivered to the executives. If there are executive contributions to the program, employers will also want to look at the present value of those. Typically, they're looking at this at their marginal, after-tax cost of money. Sometimes they're willing to take a discount on that rate because it's an investment in the human resource, but if you get into some of these companies that have very significant after-tax rates of return and cost of capital, it makes the sale of insurance much more difficult. If the plan is replacing some existing benefits, cost may be measured on an incremental basis. If the employer is committed to providing additional benefits, the decision to use life insurance may be based on its cost and benefits relative to other financing options. If this is a situation in which the buyer has to be convinced that additional benefits are appropriate, the total plan cost will be reviewed.

From a professional standpoint, I'd also like to talk about the opportunities that this market represents for actuaries. Years ago, a significant COLI marketer told me that he didn't need marketing support from the home office. He knew more about this market than they would ever know. "I need an actuary to distinguish me from my competitors and give me credibility." This is actually a great marketing opportunity for actuaries. They are viewed as being technically competent, with high integrity, and having an aversion to incomplete truths. Dry and unexciting as we may be, if we can string together a coherent sentence that isn't filled with actuarial jargon, we can enhance the understanding of the transaction.

In a recent set of broker interviews that I went through with a client, the client had his benefit actuary as well as his life insurance actuary present for all the interviews. Four brokers were being interviewed. Two of the brokers brought their actuaries to the transaction. This is one time that everybody wants to be seen in the company of an actuary. If you have an interest in traveling, this is a good way to do it.

The business that we're selling today is different from what we've sold in the past in that it is, indeed, solid business. The smoke and mirrors are going, if not gone. I think that there's a better recognition on the parts of all parties to be fairly compensated or to receive fair value over the long term in the transaction, and it is viewed much more as being a long-term partnership with an equitable and consistent sharing of risks and rewards.

MR. EISENBERG: John, who distributes these products? How are they sold? What are the different methods?

MR. RYAN: In the context of the public corporation market, distribution for many, many years has been and still is today largely dominated by a small group of specialty brokers. That is the method of distribution. In fact, I know of no carrier in the industry that has ever distributed COLI products in the public corporation market through its own in-house distribution. It's all outside distribution. We see a tendency on the part of some carriers to go direct to the clients, and we did this seven or eight years ago largely because of our existing institutional client base. Today it's still largely specialty COLI brokers with some carriers doing more business on a direct basis.

MR. EISENBERG: Would anyone on the panel want to hazard a guess as to what the market potential is? We get asked that question quite a bit from carriers.

MS. FAUCETT: How big do you want it to be?

MR. RYAN: I would simply say, Steve, that if you added together the aggregate retiree medical liabilities and the aggregate nonqualified executive pension liabilities, augmented by the $150,000 cap, plus all the group term life insurance on highly-compensated management employees in corporate America, you'd get some idea of the size of the market.

MR. STEPHEN J. O'BRIEN: I have a question for Tim Millwood regarding extending the match-mismatch concept. How do you compensate producers in the many years out when they are doing a great deal of administrative work on these plans?

MR. MILLWOOD: Are you talking about years when there are no premiums?

MR. O'BRIEN: Correct.

MR. MILLWOOD: If you don't have to deal with New York, you can certainly offer trail commissions, which is what most of the COLI writers that don't have to deal with New York do. The other way, many of these writers will just negotiate outside fees outside the contracts. If the compensation is not sufficient, that's their only choice.

MR. EISENBERG: I have another question. Are there any rebating issues on the commission flexibility?

MS. FAUCETT: As someone who has testified in California on rebating issues, it's very interesting that, while all the carriers who were named in that particular suit understood that dial-a-commission could potentially be construed as some form of rebating, at least the state of California did not allege that was a form of rebating, whether it was legalized or not. But certainly, you have to be concerned about it. One of the other issues that I have heard brokers raise as a potential rebating issue is where there is a consultant involved and the corporate buyer asks the broker to compensate the consultant out of the broker's fees. That constitutes some form of rebate to the buyer, even though money did not change hands going to the buyer.

MR. EISENBERG: Was that an answer?

MS. FAUCETT: No.

MR. EISENBERG: Tim, can a company that wants to get into this business take an existing UL, variable UL, or participating whole-life product, and just tweak it to get into the business?

MR. MILLWOOD: I think it depends on the product and who's doing the tweaking. We generally recommend a specialized product for the COLI marketplace. It's potentially possible to take an existing contract and try to modify it. It really depends on how it has been designed in the first place.

MR. JAMES L. LIVINGSTON, JR.: Tim, you said that, in recent years, the market has been dominated by portfolio-based products. Judy, you said that typically the buyers are very sophisticated, represented by actuaries, and informed buyers. What are your impressions about how well the buyers understand the concept of portfolio rates and what their reasonable expectations are in a time when the industry is bringing in new money at lower rates?

MS. FAUCETT: Quite often there is disclosure of the fact that new money is not at the current portfolio rate. Those are questions that are asked. We typically ask for illustration questionnaires (IQs) to be presented along with the policy form. If it's not disclosed in the IQ, we will ask the broker specifically to provide information about the current portfolio rate and the new money rate and to do sensitivity testing, which we hope is indicative to the buyer of what could happen if the portfolio rate drops to the new money rate, and that's the ongoing rate that is earned on the assets. However, we all know that no disclosure can ever be considered to be foolproof with a buyer. But certainly, there's every expectation that we're giving buyers enough information so that they understand that if someone currently has an 8.5% portfolio rate and a 7% new money rate, they should expect some degradation in the longer-term performance, and that's why we do the sensitivity analysis.

MR. EISENBERG: Also, new money carriers are selling these products quite successfully.

MR. RYAN: Yes, I would just add, in response to that question, that the buyer community is keenly aware of what the differences are, in fact, sometimes as much or more as the carrier. More and more, the decisions as to which product to purchase are geared to the financial side. In many cases, you're talking to the plan sponsors, who are investing $1–$3 billion in pension assets. The only thing they know is the investment year method, and they look at these deals as long-term deals. When you look at portfolio and investment year over a long term, things are going to come out equalized if the asset quality and duration are the same. There is a very high level of sophistication and a keen awareness of the differences.

MR. MARVIN D. FINEMAN: What would happen to the existing portfolio of COLI business if any of the tax initiatives now under discussion should come down on the wrong side?

MR. EISENBERG: Such as?

MR. FINEMAN: Such as limiting interest deductibility and so forth; how much is that a part of the process involved in keeping these policies in place?

MR. MILLWOOD: That would kill leveraged COLI. It wouldn't kill the regular split-dollar sales and carve-out sales.

MS. FAUCETT: But what about the business already in force?

MR. MILLWOOD: I think that right now it doesn't look like the leveraged COLI in force will be grandfathered so they would roll off the books. They may roll off in the next couple years. It depends on whether it's a cliff or a phase-out.

MR. FINEMAN: To what extent do these issues get started in the sales process for new business?

MS. FAUCETT: The buyers are keenly aware of what's going on. They seem to be more tuned in to the legislative process sometimes than the carriers and the brokers are. Just to add to Tim's comment about the in-force business, I think that if there is no grandfathering of the leveraged COLI business, including the pre-1986 business, this will be subject to the same kind of rescue programs that we saw on minimum deposit plans when that policy loan interest became nondeductible. One of the key issues here, particularly on the older blocks, is that very significant gains may have developed in those policies. When you're talking about plans that are this large, it could be very significant dollars. There's not enough cash left inside the contracts to pay the tax on the gain that would become due. If it does pass without any grandfathering, this is, again, going to be a great opportunity for the industry to come up with something that works for the corporate buyer.

FROM THE FLOOR: Following up on that, suppose that the product that had been sold was an efficient product, similar to something that Tim showed in designing. Do you have any suggestions as to what could be a true rescue program?

MR. MILLWOOD: Well, the leveraged COLI contracts would go through a process called *unwinding*. Like Judy said, you basically convert the taxable cash value gain into tax-free death benefits. How quickly or how long it takes to unwind depends on how much death benefit you're willing to pump into the contract, assuming you have that flexibility.

MR. RYAN: There are some other scenarios. Unwinding will not be the situation in every case. In some cases, switching to a separate account product will generate economics for the employers that will be within their hurdle rates and acceptable over the long term. In other cases, it may be possible to configure the existing product in a way in which the economics meet the employers' objectives. Once we have an idea of what the final tax bill will be, it's likely that there will be some alternatives, one of which will be to unwind the deal. In many of the larger deals, there are unwind agreements already in place, so the procedure is already there.

MR. ISADORE JERMYN: Tim, you mentioned return on capital as being used. When very little capital has been put in, as you pointed out, the return measures go out of sight. How much attention do you see being paid to the dollar value of capital or to return on assets or some other measure?

MR. MILLWOOD: We see a little more attention being paid on the separate account contracts. I think companies actually allocate some capital to the separate account or loans, even though they don't need to on the risk-based capital formulas, and that will generate their required profit return at that point. They do realize that you're not taking risks on separate account products. You're not taking investment risks. You can't be expected to make the same dollars of profit. I think companies are probably looking for somewhere between 25 and 50 basis points after-tax return on assets on those kind of products.

MR. JERMYN: Is this in the general account?

MR. MILLWOOD: No. This is in a separate account product in which you're looking at the secondary measure at that point.

MR. JERMYN: I have another set of questions having to do with crediting rate philosophies in which companies are using, for example, the same portfolio as their traditional participating business. If it happens to be a mutual company, what types of crediting practices do you see, and do you see much, if any, differentiation between the rate being credited on the traditional non-COLI business versus COLI, and what is the basis for that differentiation?

MR. MILLWOOD: There may be different net credited rates because they have different pricing spreads. Many companies we've looked at use the same gross rate for traditional business and the new COLI business. Some of the mutual companies agonize over that decision because essentially old policyholders are subsidizing new ones. I don't know whether it's a good decision to do that, but the ones that truly believe in the portfolio method generally lump the COLI in with everything else.

I have seen some other companies that try and segment the COLI because they figure it has different investment characteristics, and they don't really want the old policyholders to subsidize the new ones. I've seen both ways used.

MR. RYAN: Just to add to that question, it's clear that the liabilities are different. Therefore, the assets have to be different. Therefore, the gross returns will be different, and there will be a different gross rate if the assets for the COLI block are segregated. When you start to talk about these things, one of the things you have to look at is, by and large in the industry, COLI products grew out of the individual policy retail operations and, again, are still probably intertwined with those operations, including the asset base or portfolio.