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Variable Products

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Summary: This session explores the current status of variable products in the marketplace. It also covers issues related to fund performance, distribution, and product design.

Mr. Mark A. Milton: If anyone is expecting a discussion of annuity products, we will have time at the end for discussions and for questions on annuity products. However, our formal presentation will focus on life insurance.

We have really been experiencing a product developer's dream in the variable life insurance marketplace. We have had many new market entrants over the last five years and exciting sales growth. We have had a major regulatory change in the last month. In addition, we have seen an expansion of variable products into specialty areas, such as survivorship life, group life, and low-load products. Variable life is being touted as the life insurance product for the 21st century, based on its investment flexibility and the control it offers policyholders. Today's friendly life insurance product design, which includes features such as dollar-cost averaging, portfolio rebalancing, and a full array of life insurance riders, makes the product much more friendly for the consumer.

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Perhaps the most exciting thing to me about variable products is its broad market appeal. Any customer group that needs life insurance protection and values long-term cash value growth is a key candidate for variable products.

According to Ibbotson data, from 1926 to 1992 common stocks provided an average annual return of 10.5%. Government bond returns were around 4.91%. Inflation was about 3.91%. Variable products demand graphic presentation. For instance, you can describe the 4.91% government return as follows: If you had invested one inch in 1926, it would have grown to be a ruler now. If you had invested the same inch in common stocks, it would be higher than a ten-story building. You can imagine how agents and potential policyholders get very excited with the concept when you can use such graphic terms.

I would like to do a quick audience survey. We have a very good turnout. How many people in the audience work for companies that offer variable life insurance products today? Quite a large number. How many of you work for companies that are considering introducing variable products in the near future? It looks like about 15–20 of you.

We are fortunate to have an outstanding panel discuss variable life products. Nancy Kenneally will talk about variable life sales results, provide a market overview, and give a product update on some of the niche products I discussed earlier. Nancy is a consultant with Tillinghast-Towers Perrin in their New York office. Among many other things, she has been involved with designing and pricing several universal life and variable life products. Prior to joining the firm, Nancy spent six years with New England Mutual Life Insurance Company.

Tom Connor is going to discuss important new regulations affecting variable products. Tom is an attorney with the Washington, D.C. law firm of Sutherland, Asbill and Brennan. He joined the firm after practicing at the Securities and Exchange Commission (SEC) for four years. So Tom will have many exciting insights to offer. Prior to working at the SEC, Tom was in private practice with a major Boston law firm. He has written extensively on the subject of mutual funds and variable insurance products.

Finally, Tim Pfeifer is a principal in the Chicago office of Milliman & Robertson. He specializes in the area of life and annuity product design. Tim is going to provide insights into the overall profitability aspects of variable products.

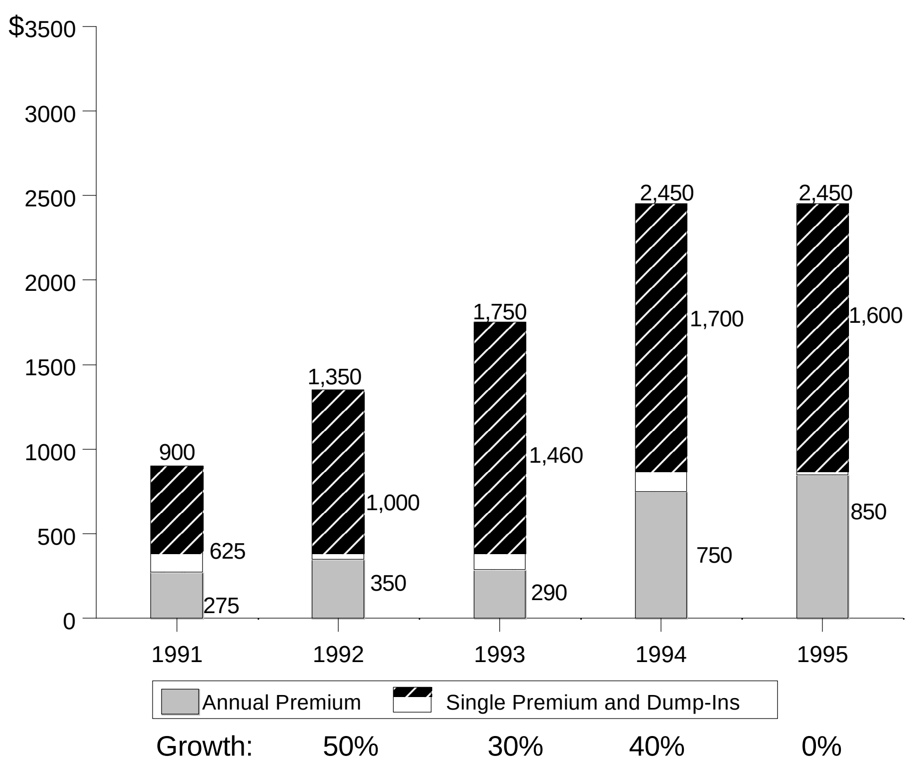
My name is Mark Milton. I'm with Kansas City Life Insurance Company. Over the past year, we have introduced a new variable annuity product and a variable life product.

Ms. Nancy M. Kenneally: I have been asked to give an overview of the variable life market—essentially an update on what has been going on in the last year or so. I will be focusing on three main areas: (1) what sales have done recently; (2) what the market looks like; and (3) what some of the products in the market look like.

Let's start by taking a look at what variable life new premium sales have done over the last five years.

These sales figures in Chart 1are taken from Tillinghast's VALUE survey. They represent first-year premium only for both fixed and variable accounts. The graph shows annual premium, which is the top portion, and single premium and dump-ins, which is the bottom portion. Single premiums are included at 10% on the premise that a single premium is roughly equivalent to ten annual premiums.

CHART 1
TOTAL VARIABLE LIFE SALES



Note: Figures reflect the approximately 50 companies that are currently selling variable life. The 1995 figure for single premium and dump-ins includes approximately $35 million (10% of 350) for single premiums.

Source: Tillinghast VALUE Survey (includes first-year premiums only, fixed and variable account,single premiums included at 10%)

So, what have we seen over the last five years? We have seen tremendous growth in new premium sales ranging from 30% to 50% per year. For 1995, however, we see a significant slow down. In fact, sales totaled roughly $2.3 billion, which is approximately a 4% decrease over 1994.

It's interesting, however, to look at the same market results if we exclude the top two players. As we said, we see a 4% decline from 1994–95 when looking at the total market. If we exclude the top two players in both years, Equitable and Prudential, then we actually see that there was a 13% increase in sales for the rest of the market.

If we take a look at variable life market share in 1994–95, we see, too, that this has remained relatively constant. Variable life accounted for 19% of total individual life new premium sales in 1994 and 18% in 1995. These figures were taken from a Life Insurance Marketing and Research Association survey and may be slightly on the low side because 4 of the top 20 variable life (VL) writers have been excluded.

What about 1996? This same survey shows VL market share at 24–25% through the second quarter of 1996. As market share continues to move up, an increasing number of smaller companies may feel obligated to start offering variable life products. We see that VL sales through the second quarter of 1996 tell a different story than what we saw in 1995. New premium sales, again with single premium included at 10% through the second quarter of 1996, totaled $1.6 billion, an increase of 45% over the same period last year. Given these results, we might expect total premium sales for the year to approach $3 billion.

What are some of the reasons for these increases? The primary driving force behind the tremendous increase in sales is that agents are increasingly becoming more familiar with variable products. They now, in fact, lead with variable products, as opposed to fixed products. Initially, the large VL writers were companies with large captive agency systems, or career agents such as Prudential, Equitable, Hancock, and IDS. This essentially eliminated agent brokering of business, and variable life products began to look more attractive than fixed products due to VL's lower capital requirements over fixed products and increased senior management focus. More recently, sales have begun to expand to companies with independent sales forces and alternate distribution channels: Allmerica, Pacific Mutual, and Merrill Lynch.

Other reasons for the increases are: (1) new agents are more likely to sell variable products than fixed products as opposed to older agents; and (2) greater consumer awareness fueled by both the low interest rate environment and more agent education.

Let's look at the VL market. The variable universal life (VUL) market has become somewhat saturated. We saw only a handful of new entrants to the VL market in

1995–96. Mark's company, Kansas City Life, as well as United Investors and North American Security Life were a few that entered near the end of 1995 or the beginning of 1996. Additionally, we have not seen many brand new VUL products introduced to the market, but we have seen several reprices of VUL products or second generation products. Companies that came out with new VULs in 1996, or repriced products in 1996, were Fortis, Lincoln National, Phoenix, and Guardian. Most product development in the variable life market has been by current market players bringing out alternate product designs. These would include survivorship VULs, low-load VULs, single-premium VULs, and group VULs.

I'm going to focus the rest of my presentation on these alternate product designs. First, I will give some specific market/sales information, and then I will describe what the typical design might look like.

We'll start with survivorship VULs. Although survivorship sales have mirrored the general life insurance market and have remained relatively flat over the last couple of years, the market share for interest-sensitive products, or survivorship interest-sensitive products, has increased dramatically. In 1995, interest-sensitive products accounted for 63% of total new survivorship premium, compared to 1992, which accounted for only 17% of new survivorship premium. Survivorship VUL sales through the second quarter 1996 totaled $80 million for the nine companies that we have reporting in our value survey. This compares to the 1995 total, which was approximately $81 million for the entire year. We have seen several new product introductions in 1995–96. Most notably, in 1996, Aetna and Prudential have introduced new survivorship VUL products. In addition, we are aware of three other products that are currently being developed with introduction dates for 1996 and early 1997.

What do these products look like? They are essentially used to fulfill needs of two niche markets: (1) to provide estate protection, and (2) to provide a means to accumulate supplementary retirement income. Many of the products are designed to utilize front-end loads because the cost of insurance charges provides lower margins in these products. Most use the typical single life VUL chassis, that provides flexible premiums and flexible death benefit in an unbundled product design. Also, most products provide enhanced death benefits and an important feature of guaranteed minimum death benefits—generally allowing the policyholder a choice of whether to keep this to a certain age, such as 75, or to keep it until age 100.

Next, we will take a look at low-load VUL. Currently, we are aware of only three companies that are offering low-load VULs and these are offered through financial planners and direct marketers. There are very few of these products out there, and we don't expect them to be the wave of the future. I've included them because they are an example of variable life reaching into alternate distribution channels. To date, the cumulative sales from these products are pretty small—roughly $1 million cumulative among the three products at the end of 1995. The newest introduction is Ameritas' life product at the end of 1995. These products typically utilize an asset-based charge structure, and have substantially lower commissions than the current individual VUL products that we are typically seeing in the market.

Just a few observations on this low-load product design. As I mentioned, they utilize an asset-based charge structure. Full-loaded products generally recover their distribution costs through both front-end and back-end sales loads. There are mortality and expense (M&E) risk charges and margins in the cost of insurance (COI) rates. We would expect low-load products, because of their low distribution cost, to be able to eliminate the sales loads, both front-end and back-end, and to have lower M&E risk charges and reduced COI rates. In order to produce a competitive illustration, it may be necessary to reduce or maintain a low-level M&E risk charge. Some of the problems that we see with asset-based expense and tax charges, although they're simple, are a mismatch with actual expenses. This results in not enough revenue at low funding levels and too much revenue with full funding which, in turn, hurts competitive positions and illustrations. Maintenance expenses are generally a better fit with per-policy loads. And premium and deferred acquisition cost (DAC) taxes are generally a better fit with percentage-of-premium loads.

The last product I'd like to talk about is group VUL. As mentioned earlier, there has been increased interest in group VUL recently due to the continuing popularity of variable products in general. There has been an increase in demand for flexible products, as evidenced by the group unfunded liability (UL) products, as well as improvements in technology. This allows for better administration of the product, especially on a case-level basis. It also allows efficient administration of SEC regulations. We've seen a flurry of new product development in this area—at MetLife and, most notably, at Minnesota Mutual (at the end of 1995). Sales results for these products are generally not available due to their newness, but we've seen them replacing several of the group UL products that are out there in the market. These products also utilize the typical individual life VUL chassis providing flexible death benefits and flexible premiums in an unbundled product structure.

Most of the features that you find in these products are typical of individual VUL products. These include partial withdrawal provisions and investment options. The charge structures are similar to individual VUL products, with some exceptions. We generally see lower front-end loads, and lower mortality and expense risk charges, at least on a current basis. Several of the products have both current and guaranteed M&E charges. We see no back-end surrender charges, which is a big switch from individual VUL products. Also, COI charges used attained age-scale rates in contrast to select-and-ultimate rates typically used in individual VULs.

Another major difference is the underwriting. Group VUL is typically guaranteed issue or simplified issue. Other differences between individual VUL and group VUL are: (1) group VULs generally charge actual premium tax by state as opposed to an average, which is typical on a VUL product; (2) compensation is generally much lower than on individual VULs, making use of trail commissions; and (3) most currently available products offer case customization on specifics of the case, such as underwriting requirements, commissions, and, of course, sales loads.

Mr. W. Thomas Connor: I'd like to talk about some new legislation that will directly impact the development of variable life insurance as well as variable annuity contracts. It's probably hard to overemphasize the importance of this legislation.

Just this month, on October 11, President Clinton signed into law legislation known as HR3005. It is more formally known as the National Securities Markets Improvement Act of 1996. President Clinton understood enough, or perhaps his staff understood enough, to say that the legislation represents the most significant overhaul of the securities regulatory structure in decades. HR3005 does many things. I will only cover the aspects that affect variable products.

HR3005 amends the 1940 act—the Investment Company Act of 1940—to remove the statutory authority of the SEC and to regulate variable contract charges by eliminating the regulatory straitjacket that has pervaded the design and impeded efforts to price a contract rationally. HR3005 promises to usher in a new era of product design, which sounds like a cliché, but I really think it's true.

First, I thought we'd go through a thumbnail sketch of where we've come from, and then look at where we are. We, as well as you, are just beginning to explore what the ultimate effects of this legislation are going to be. As I'm sure most of you know, variable contracts are regulated as securities under the Securities Act of 1933, and the separate accounts that are used to fund the contracts are regulated as periodic plans under the 1940 act. Periodic plans were historically types of installment plans where the agent would literally come to your house every Friday night and collect $5 from you— sort of a poor man's mutual fund. They were subject to very high excess loads that were deducted primarily in the front end. Often the shareholder would drop out and lose all his money before he or she accumulated a fair amount of value. Because of the regulators' periodic payment plans, and because periodic plans were subject to such abuse, variable contracts have also been subject to heightened 1940 act regulation that focuses on the types of sales loads, the related charges, and the manner in which they can be deducted or refunded.

Believe it or not, the SEC has recognized all along that this regulation is not particularly rational. I can tell you from experience that when somebody gives you a job, you think you have to do it. Accordingly, in 1992, the SEC issued a large report basically on modernizing the 1940 act. There was a chapter in that report on variable contracts. The staff recommended that the regulatory framework be replaced with a simple requirement. That requirement states that the fees and charges in the aggregate under the contract be reasonable in relation to the services, the expenses expected to be incurred, and the risks associated with the contract. Well, where are we now? Congress acted on the SEC staff's recommendation by including in the HR3005 amendments to the 1940 act eliminating SEC regulation of charges and expenses. This is not to say, of course, that the SEC has lost all its jurisdiction, because it will continue to regulate separate accounts and contracts. It simply will not have the quasi ratemaking authority that it has had for 50 years. Instead what has imposed is this reasonableness standard. It's going to be months, if not years, before we understand what this standard is and how it should be tested. Congress also injected one other important requirement in this legislation—the charges are gone. You no longer have the charges, but you do have to determine that the contract is reasonable. More importantly, from a congressional and liability standpoint, the company has to represent that the charges and fees under the contract are reasonable in the contract's registration statement.

The commission was authorized to pass rules on fees and charges, but the staff indicated in 1992 that it would not expect to engage in that practice. It's interesting that what they have done is almost a coup d'etat. The SEC said it no longer has to regulate fees and charges, but if and when it does, it will have clear statutory authority over all charges in the aggregate. Whereas, the industry has maintained for many years that the risk charges—the other charges related to the risk under the contract—are insurance charges. And since variable contracts are, as we all know, half securities and half insurance, or some percentage thereof, it has never been clear that the SEC had the statutory authority to regulate M&E charges. It did so primarily because it does have jurisdiction over sales charges.

As many of you know, the commission was concerned that you would jack up your M&E fees to cover the fact that sales loads are subject to a cap, the legislation does not specify where in the registration statement this representation has to be made. The staff has been telling us, literally, day by day, that it can go into part C of a variable annuity registration and part 2 of a variable life registration. That probably won't make much difference, but there is some special liability accruing to misstatements in a prospectus. But there are also broader statutory prohibitions, including misleading statements and registration statements. So it doesn't seem to do much to pull it out of the prospectus. The legislation also does not specify whether the underlying fund fees and expenses must be included in the aggregate standard of reasonableness. I think it's clear, at least in my mind from the 1992 report, that the staff did not want to have these charges included. Unfortunately, the statute basically includes all fees and charges under the contract (whatever that means). The House report also says advisory fees should be included. Probably, the conservative approach is to include those. But as some of you know, fund fees are already subject to another reasonableness requirement under the 1940 act. So it's a little perplexing. Which test should you apply? If you apply two different tests, it’s not clear what standard you would apply to them. You might simply say, "I'm not going to treat those fund expenses as part of the contract expenses."

Well, so much for where we are now. Returning to the reasonableness standard—there are no requirements on fees and charges on the variable product. We do know that they have to be reasonable and that our insurance company has to represent that they are reasonable. We know that the directors sign that registration statement.

So what do actuaries, lawyers and management have to do to determine this reasonableness? There's nothing in the legislative history that tells us what “reasonable” is suppose to mean. All we have is the 1992 staff report from the SEC, in which the staff said, basically, it's a facts and circumstances test that may require difficult determinations, but that’s not very helpful.

The report also indicates that the insurer can take into account the nature and extent of services provided under the contract, the benefits conferred on the owner, and the risk assumed by the investor. This seems to be a restatement of the services, expenses and risks test that is part of the reasonableness test, although the staff did go a little farther than the 1992 report, so maybe we take some comfort in this. They said that variable contract issuers should have the same flexibility that mutual fund issuers have in setting product charges, as long as the charges are plainly disclosed and not excessive. They have to be nonexcessive. What does that mean? The staff said that mutual funds generally are not subject to numerical limits on their sales loads. Instead, the focus of the regulation of mutual funds is the prevention of excessive charges while giving fund management appropriate business flexibility.

For purposes of further analysis, let’s break down the contract, into two camps. The first camp, includes existing or new contracts that continue to meet the SEC’s limitations that it imposed up to the new legislation. Particularly, many of you know that you have to prepare an actuarial memorandum for both annuities and life that says that the M&E charges are either within the range of industry practice or reasonable in relation to the risk assumed. You no longer, of course, have to apply for exemptive relief for M&E charges, for risk charges or for any charges for that matter.

But how about these old standards that the commission staff used to use to justify the reasonableness of an M&E charge? Could we apply that as a whole to the contract? Well, that's probably a good idea, although the staff report of 1992 said that would only be one factor instead of the whole ball of wax. That factor, of course, is the representation that the contracts are within the range of industry practice. That's probably a good thing to consider when you consider the reasonableness.

But what if you're faced with a fairly new contract, such as the modified single premium contract, that is new enough to not really have industry practices established yet? Within the range, on the old ones, you sort of stack up the prospectuses and have a memo that says it’s reasonable, it's within the range of industry practice, and that you have a stack of prospectuses to prove it. That's not enough. Do you then go to the reasonable in relation to the risk assumed, and use the same type of stochastic analysis that you did to get the M&E charges? Well, if it's not within the range, that's probably a good place to start. It gives you some hard data. Is it reasonable in relation to the risk? Run your stochastic analysis and look at the expected outcomes. What is the cost to the company? If you build in a cost of capital and a profit margin, you probably have some pretty good evidence of what is reasonable.

As far as sales loads go, let's review how you look at each of the charges. The staff stated in the 1992 report that insurers should consider the nature and quality of services necessary to ensure proper distribution of a contract. Well, that's helpful and certainly broader than the 9% limitations we've lived with, because you have a contract that costs more to distribute and you can charge more for that. As you all know, administrative charges were required by the SEC to be at cost. They no longer have to be at cost. Basically, you look at the nature and quality of the administrative services. With respect to risk charges, again, if it's not within the range of industry practice, perhaps you've used the stochastic analysis to show that it's reasonable in relation to the risks. As far as COI charges go, there are certainly established industry practices on that side.

We are just beginning to address the question of how the reasonableness determination should be documented. Part of that, of course, will depend on company culture. The SEC may start asking to see how you've made this determination of reasonable charges when it performs an inspection. Your directors may ask for some type of written analysis. Finally, a great deal depends on what type of civil liability is going to result if the representation in the registration statement turns out to be misleading. It's particularly complicated when you work your way through the federal securities laws to determine what statutes might be applicable in either a private litigation or if the regulators—particularly the SEC—were to challenge the charges and fees. Maybe you don't want any proof in the record. Maybe you do. It depends on who has the burden of proof. And, as I said, that's an issue that we're just beginning to work our way through.

So what does this mean for the industry? Variable annuity markets, of course, are saturated. And there's low-load and no-load variable annuities. It’s probably difficult to imagine that charges would increase in that market. But what you do have is additional flexibility. Perhaps you don't want to have an M&E charge. Perhaps you don't want to have a sales load charge. Perhaps you just want to have one charge. Contract costs 250 basis points—you can put that on a sign in front of your broker's desk. That's one of the exciting things about the legislation. Not only are there no numerical limits on the fees and charges, there's also a great deal of flexibility in not having to break out charges. The registration forms under the 1933 and 1940 acts, of course, require a discussion of these various types of charges, but it's possible that those may be subject to no action relief from the SEC staff. The staff might say, "Just show us what you want to do, and for the time being we'll ignore the registration statements."

It seems, however, that with VUL, there's going to be much more innovative design. You don't have the gap considerations of sales loads. You can load it heavily up front to coincide with the commission payments. Of course, all of it has to be reasonable. The sales loads provisions were important. The administrative costs under a VUL policy is now subject to no limits. So you can charge what you think is a reasonable profit. I think it's interesting to note that in the variable life, not only will we see increased product charges, but we will also see a fair amount of innovation as well.

Mr. Timothy C. Pfeifer: The focus of my presentation will be on five major propositions of variable life profitability. I think organizations, in large part, tend to have serious concerns about whether or not variable life insurance provides an adequate return on invested capital. They look at the marketplace and see that there are a fairly small number of companies dominating the marketplace. The organizations wonder if they will ever achieve the types of production that will give them the return they think is appropriate. The systems cost and some of the other issues associated with getting into the variable life business have been well documented. There is obviously a potentially great expenditure of time. I think that's one factor keeping companies on the sidelines in many cases. It will be interesting to see, with this new amendment to the investment company rules, whether or not more companies will find it attractive in terms of how they can price products. I will address that later.

I'd like to discuss variable life pricing assumptions that most heavily influence profit testing. The first is the fixed versus the variable mix. I would say most companies would tend to price the fixed and the variable components separately and then try to ensure that each one stands on its own. Then they make some assumption as to what the mix of the business will be and ensure that, in aggregate, it meets their requirements. Currently, companies seem to be choosing a 20/80 mix—20% fixed/80% variable—as something that they think is reasonable. Other companies would tend to do a blended profit type of analysis and, on that basis, try to make certain that overall profitability makes sense—the factor determining whether the product is doable or not. Some companies price with the assumption that there are a host of different subaccounts, and each subaccount has its own anticipated return. More often, companies assume that the variable account will earn around 9% or 10% on a gross basis, and then see how the pricing flows through from that.

Mortality assumptions vary dramatically depending on company experience, but typical assumptions would be close to society-type averages, typically 75–80% of the appropriate version of the 75/80 table, whether that be nonsmoker or smoker. It is common for companies, especially on VUL, to make an assumption of some mortality improvement on the order of 0.5% or 1% a year.

Surrender assumptions is another critical area. A 12% initial lapse rate grading down to 5% would not be atypical. A standard rule of thumb that we would then use on variable annuities and variable life would be that lapse assumptions are roughly two-thirds of what they might be on a comparable fixed product.

The loan utilization assumption is also important, especially if the company offers wash-loan provisions. It's important to attempt to model that. For products that don't have wash loans, or that have periods where there aren't wash loans, an assumption of higher loan utilization can actually add more profit to the product. So the loan assumption can become critical.

Expense levels are a very important factor. Most companies are not pricing with fully allocated expenses on their VUL products. An assumption like $55 as a maintenance expense might be typical for a single premium variable life product going up to as high as maybe $75 or $85 for a VUL. My impression is that, on average, companies are probably pricing with expenses that are about three-quarters of fully allocated expenses. Then, of course, you have issue expenses of about $150. In addition, there are underwriting expenses on top of that.

Risk-based capital (RBC) obviously is another key factor. Most companies currently are pricing at around a 200% RBC threshold on a 100% scale. Some companies that are AAA rated might be pricing for something a bit higher than that, but on average 200% is about where companies are pricing.

The business mix is another important component—especially if you have a single premium variable life contract where you have asset-based charges that are essentially the same for everybody or with few deviations. The actual business mix can have a very big bearing on whether or not the product performs well profit-wise.

The other key factor is the actual and the assumed mix among smoker and nonsmoker and preferred classes. Most companies find smokers to be more profitable than standard nonsmokers who are more profitable than preferred nonsmokers. Typical profit levels are shown in Table 1.

TABLE 1
COMMON PROFIT LEVELS FOR VARIABLE LIFE CALCULATED UNDER MICROPRICING WITH PSEUDO-MARGINAL EXPENSE ASSUMPTIONS

	Statutory IRR	**Profit Margin**	**ROA**	**GAAP ROE**
Variable	12–16%	2–5%	40–70 bps	13–18%
Fixed	11–14%	3–6%	50–75 bps	13–17%

If we were to contrast that with variable annuities, we would see on the variable side a statutory internal rate of return (IRR) of 13–17% on variable annuities. On the fixed side of variable annuities we would see an IRR of 10–13%. The return on assets is 25–35 basis points on the variable side and 25–40 on the fixed side.

It is important to understand the source of profit. A primary source is cost of insurance in excess of experience mortality. We see many VUL designs that are reverse select and ultimate so that much of the mortality profits are heaped into the early years. And, as I mentioned earlier, it's not uncommon to assume some sort of mortality improvement going forward. The mortality spread can become an important and troublesome issue when you have asset-based cost of insurance. Things tend to work in the wrong direction. You're not getting as much asset-based COI at the times when you need it. There are companies who are putting floors on the asset-based COI so that you are assured of getting a certain level of COI revenue even when the funds are underperforming. Many products give the company the ability to come back and charge something higher than the asset-based COI might indicate that they should be charging. The asset-based COIs are certainly becoming very popular on the single premium version, but there are some pricing risks that you have to deal with to make sure that you're properly covered.

The next source is fixed interest spreads and variable M&Es. Most variable M&Es are either 90 basis points or 50 basis points, depending on the structure. When pricing, some companies fail to annualize the 90 basis points or the 50 basis points so as to eke out those few more basis points that really are available because the M&E is coming out on a daily basis. On the fixed side, the fixed spread varies anywhere from probably 130 basis points to 160 or 170 basis points. This is not dissimilar from what you might see on a regular standalone product.

Fund management fees are also very important. On the variable annuity side, there are a number of situations where the base variable annuity contract does not in itself yield any profit or much profit. In fact, in some cases it's a loss. The product is a conduit for providing funds from which the insurance company can get management fees. That's not the norm, but it certainly is not uncommon either. It is less common to see that kind of conduit type of approach on a variable life product where the life product is just a chassis for getting funds in the house. It's more often the case that the insurance product is actually providing profits on its own. Nevertheless, the ability to get some share of fund management fees is important from the variable life contract as well.

No-lapse and guaranteed minimum death benefit charges are also important to consider. Some companies do charge explicit fees for having a no-lapse or a guaranteed minimum death benefit (GMDB). Those can take many different forms.

Expenses tend not to be a source of profit. The SEC does not want you to have a profit emanating from your expense load. The expense loads being charged are not fully covering the actual expenses.

Now let's discuss the product design features that most directly affect variable life profitability. The first is the asset-based charges that we talked about. These have to be capped at 1980 CSO levels. So if you are using asset-based charges on a single premium version, you still have to abide by the 1980 cap. Some companies are starting to band the asset-based charges so that when the funds hit a certain level, the level of the asset-based charge will go down. In a way, it's kind of a reverse select-and-ultimate kind of effect which, as I mentioned earlier, we are seeing quite frequently in the competitive VUL market, and with the potential for an illustration rule that will impact variable life down the road.

No-lapse guarantees and GMDB seem to work one extreme or the other. They either tend to be very expensive provisions, or they tend not to cost the company much at all. On the annuity side, we're certainly seeing GMDB benefits becoming more modest. I suspect we'll see some of the same thing happening on the life side.

The type of typical risk classes for VUL products available has preferred nonsmokers, standard nonsmokers, and smokers. There are very few preferred smokers, though they do exist in some situations. The single premium variable life side tends to be just smokers and nonsmokers. We tend not to see preferred classes on the single pay business.

We have seen a trend towards increasing quantities of fund choices on all variable business. We are still seeing almost every product having some sort of fixed option, although it may not be priced very competitively. We have not yet seen market value adjusted life subaccounts as we have seen on the annuity side, but who knows?

Single premium products are routinely operating with minimum premium levels of $10,000 or more in order to increase the asset base. Many of the VUL products have some sort of minimum premium requirement to engage the no-lapse guarantee, and those are minimum premiums that vary by risk class and age, and so forth.

On the commission side of VUL products, we generally see commissions that are very much in line with those paid on fixed UL products. They can vary anywhere from 70% of the commissionable premium all the way up to 110% or 120%, which obviously creates somewhat of a pricing issue when your sales loads are contingent.

On the single premium variable life side, many of those products are starting to pay a trail commission, much like a variable annuity. Total growth compensation up front is still in the 6–7% range without trails. Trails are becoming a bigger part of the single premium marketplace.

Earlier, I alluded to illustration issues. We do not have illustration rules right now for the variable life side. However, we think they're coming soon and will challenge many products that are currently available. They are lapse supported in the sense that some of the current fixed UL products have been lapse supported. The use of persistency bonuses is not as prominent on the VUL as they have been on the UL, but the reverse select-and-ultimate tactic has been common in many of the VUL contracts.

On the single premium variable, banding your assets in calculating COI charges, in effect, is a reverse select-and-ultimate-type approach that may create problems for those contracts. It will be interesting to see how the variable life rules influence product design in the future.

Another item is load structure, which certainly influences profitability. We do see more companies with explicit DAC tax and premium tax charges. Those are permissible and can be justified if your product does not have an explicit load. If your product does have an explicit load, you are probably funding it, or hopefully, you are funding it out of another source, which you may not need to be funding out of.

Liquidity out of the fixed buckets is another issue. How frequently do you allow money to leave the fixed buckets? In what amounts? I'm talking apart from dollar-cost averaging. It is common for companies to impose some sort of restrictions such as a quarter or a third of the money coming out of the buckets at any point.

For these products, 7702 compliance continues to be guideline premium and corridor driven. There are, however, some unique questions: for example, there are the guideline single-premium calculation, which the law says to calculate at an interest rate equal to the greater of 6% and the guaranteed rate. We don't have a guaranteed rate here, but given that we do have 6%, can we reduce that 6% by asset-based charges? That seems to be a question that comes up more and more as companies are trying to figure out ways to boost their guidelines. Depending on how you design the product, I think you can reduce the 6%. In most cases, however, I think you can’t. Obviously, you would want to consult tax counsel for that, but there are a lot of interesting questions when it comes to 7702 compliance with a product like a variable with asset-based charges.

In conclusion, I want to share some observations about the amendments to the investment company acts, and what influence they may have on pricing and profitability for variable products. It is noteworthy that compliance of charges, in aggregate, is what is at issue, and that raises many questions. Are charges reasonable if they maintain current industry levels of profitability or past specific-insurer levels of profitability? Or is it neither? These are interesting questions. Where are we going to set the threshold? Most companies would be happy if the threshold were set higher than where current levels of profitability are set now. It may be that insurers are able to charge loads having a more generous cushion in them, especially if those loads are supporting experience that is somewhat unpredictable or nebulous. We have not had this luxury in the past. We anticipate that some companies will add contingency margins to their load structures to counter some of the uncertainty. This question is made more difficult by the nebulous nature of the M&E these products have contained for many years and which sort of fits many dual roles.

Given the comment on the load structure, I guess one logical question is, can we expect the profitability of variable life products to increase because of what's happening? I don't know the answer, but I'm willing to guess. My thought is that, for the short term, the answer is yes. But I also believe that the existence of the new rules will attract more companies into the marketplace when they see that there is more pricing and design freedom in these products. More entrants will probably lead to higher compensation. Higher compensation will probably lead to lower profitability. So I'm not sure we're going to end up at a point that's much better than where we are now. At least for the short term, I think profitability can increase.

I also think that it may take a longer time for companies to gain approval of their variable life products and variable annuities, for that matter. We've had rules that, while they may not be liked or agreed with have been clearly explained, and people know the boundaries when they file their variable products. We're going to have a situation now where the boundaries aren't as clear, and so the amount of time needed to gain approval could increase significantly.

I do think that we will see greater flexibility and simplicity in product design. Many of the VUL contracts now have six or eight different levels of load charges, and just going through and itemizing all the loads becomes sort of unwieldy. With the new rules, hopefully, all of that can be streamlined a bit.

Mr. John M. O'Sullivan: How do you think the reasonable standard for mutual funds compares and contrasts with the reasonable standard for insurance products? If you're not making much profit, does that mean that you have a reasonable level of charges?

Mr. Connor: I'm glad you asked that question. The staff did say in the 1992 report that its ultimate goal was to permit variable contracts to have pricing flexibility the same way that mutual funds do. I think I indicated that the staff went on to say that mutual funds currently have more freedom to set prices than variable contracts. So, how are mutual fund prices regulated by the SEC? Section 22 basically says that the commission or the National Association of Securities Dealers (NASD) can set sales load levels. For years, the commission tried to avoid that responsibility. Finally, the NASD, around 1991 or 1992, amended old Section 26 of the Rules of Fair Practice to put the current sales load caps that we have on mutual funds. It's quite complicated. There are three or four different levels depending on if you're charging a 126-to-1 fee or if you charge sales loads on reinvested dividends. But the overall cap is about 7–7.5%.

Section 36B covers advisory fees paid by mutual funds. In amendments made to the 1940 act in 1970, Congress authorized private litigants and the SEC to sue investment advisors for breech of fiduciary duty. The standard under that has been held by the courts to mean that if advisory fees are so disproportionately large that they could not have been the product of arm's-length negotiation, then the advisor is in trouble. There have been a number of cases brought on that and nobody has won to date. Even though it's fiduciary standard, it seems that courts have applied it quite broadly. So, really, where are you on mutual funds? Section 26 says you can't charge more than 7.5%. I think I failed to mention, because this panel is focused on variable life, the NASD does have a current sales load rule for variable annuities. You can't exceed 8.5%. And that's probably why you've seen a fair number of prospectuses that say that they will test on redemption for compliance of the 8.5% limit. That will continue for variable annuities. The NASD has not indicated any desire to withdraw that. The NASD has just proposed an amendment to old Section 29 (the rules have been renumbered recently), to impose other requirements on variable life, but they did not pose a numerical limit. It's a bit ironic. Our understanding is because the NASD concluded in their insurance-affiliated member committee that variable life sales loads are already regulated under the 1940 act. Then about two weeks later, the 1940 act regulation was withdrawn.

Where does that leave us for variable life? Again, you're back to the reasonableness test, because I don't think the NASD is going to get into passing a complex rule about sales loads along the lines of 63T. I just don't think they have the resources. So there are no specific limits. Mutual funds are subject to 7.5% or excessive advisory fees. If you want to apply that to variable life, I'm not sure where you end up. You still don't have any sales load limits. I guess the help is that if you are looking at aggregate fees and charges and include your advisory fees in the whole fee structure to be tested against the reasonableness standard, you can get some guidance from the 36B cases. In doing so, you can say that the fees have to be reasonable and that may mean so disproportionately large that they couldn’t have been the product of arm’s-length negotiation. But, we'll just have to see what happens.

Mr. Milton: Nancy had indicated that in 1996, the market share of variable products, the way LIMRA measures it, had grown fairly dramatically. Would anyone like to comment on where you think that market share number will be by the year 2000? Will it be above 50%? How many in the audience think that market share of variable life products will be over 50% by the year 2000? None of you?

Mr. Pfeifer: The answer to your question depends, I think, on where the market goes. If we have the same kind of market that we've had in the last ten years, I think quite easily we could be approaching 50%. I guess I still have my doubts that we'll have over half of the market be variable life. But, if we have a bull market or a semi-bull market, I could see a lot of companies just wanting to get out of that investment risk, and I think we could approach that level.

From the Floor: I have a question about historical performance illustrations. If you're adding a fund to your portfolio that has an existing history, do you have to illustrate the fund's entire history? Or can you pick and choose how many years you want to show?

Mr. Connor: Just a little background. Both the NASD and the SEC permit you to advertise, in supplemental sales literature, or in the prospectus, performance data for your variable life contract—although, for the variable life contract, that is calculated on the assumption that the separate account was going down the track at the same time the fund was. We view that as nonstandard performance data. So I think under 482, you probably have to give one, five, and ten years, or since the inception of the fund if it has not been in existence for ten years. All of that should be caveated, though, by the fact that variable life performance data is very difficult to use.

The SEC decided years ago that you couldn't use underlying fund performance by itself. It said, if you wanted to use variable life advertisements, you had to advertise separate account performances and come up with some way to deduct COI as well as sales loads. Nobody could really figure how to do that, and so, variable life performance data and variable life supplemental sales literature has not been widely used, if at all. Technically, I think the answer to your question is, I don't think you are under any specific limitations under the securities laws, because you're probably using it as nonstandard performance. This means you have to give the performance of the separate account as well. The prudent and conservative approach would be to determine how long the fund has been in existence and use one, five, and ten years, if you can.

From the Floor: A question for the actuaries on the panel. A particular product feature that I've seen in the market allows the policyowner to designate the various separate accounts from which the various charges will be picked, rather than pro-rate allocated among all of the various separate accounts. What are some of the varieties of approaches to that? Do you see any pricing implications there?

Mr. Pfeifer: As far as your question on the charges, I would say the majority of companies still do a pro-rata approach. That's the way their system is set up, and making a modification of their system to allow for directed charges is probably in many minds more expensive than the benefit. I see some products that do allow cherry picking from each of the funds. Sometimes there's a limitation on how many funds they can come from, and the level of the charge has to be at least at a certain minimum level. You can't deduct $3 from a given fund. There must be some minimum level over which the deduction has to be taken. The biggest pricing implication, from my standpoint, is just the expense of being able to facilitate that.

I suppose if you have the more volatile funds, you may not want to have a scenario where those can be run dry. And you may want to limit the amount of charge that comes out of the more volatile funds. But, I think from my perspective, the pricing risk mainly comes from the added expense that is involved in administering it.

Mr. Milton: Earlier, a number of you raised your hands to indicate that you do offer variable products. How many of you are considering doing an equity-indexed type product to supplement your variable products as well? We do have a couple of hands going up in the room. I think that's an interesting concept, and how you position those two products together is very interesting.

Mr. Daniel Theodore: I had a question regarding cherry picking loans out of the various funds. Is anyone choosing to do that? Does that have pricing implications? My second question is regarding the selection of funds. Is there more momentum still for adding more and more funds, internal and external? Are the companies that are joining the market coming in with external fund managers or internal fund managers? Are they looking to bring money under management, or are they just looking to manage the insurance risk?

Ms. Kenneally: From the funds perspective, we have seen that most companies with new products have external fund managers. They want funds with name recognition to attract new customers. If they are already investing in a fidelity fund, then the sales pitch is, "You can still invest in the fidelity funds through this life product."

Mr. Milton: In our case, since we just came out with products a year ago, we are going to look at additional fund managers for our next round of enhancements to these products. We have three outside fund managers now. The main driving force for us is to find fund managers who have lower expense loads and lower investment advisory fees so that our illustrations look better. *Morningstar Mutual Funds* recently had an article about that.

Mr. Pfeifer: I would agree with the comment that more funds are being added, and there is still a great impetus to bring in outside fund managers. But I would also say that the need to somehow share in the asset management fees is becoming every bit as important on the life side as it has been on the annuity side—whether it means having internal funds or obtaining reallowances from the fund managers. On the variable annuity side, close to half the profit for many companies is asset-management related and it is 100% for some companies. So, I think the big challenge when you are adding outside managers is to negotiate a reasonable reallowance deal with them.

Regarding the loan question, I haven't seen anybody who allows you to cherry pick the buckets. There are some pricing implications. I think, ideally, you would be indifferent as to which buckets the money is coming out of. But, in reality, especially if you are managing internal funds, there's probably different implied profitability in some funds than others, and you would prefer that the low-margin buckets are those from which the loans are taken. But with outside fund managers, I think you want to be careful with the volatility questions if you have funds that are extremely volatile. You probably don't want to be borrowing all of the money out of that fund and run the risk of depleting it. Again, I think you would want to have minimum requirements—do not allow $32 to come out of the fund. But I haven't seen anybody that allows cherry picking. If anybody's doing that, maybe they could offer a comment.

Mr. Milton: The last thing on my list is the exchange programs. Again, we just came out with variable products in the last year. That's obviously a very hot topic. I'd appreciate any comments anyone in the audience has. I sat through another session at this session on ripe annuities. I think a speaker indicated that on their fixed variable annuity program they had thought about several issues. This company actually come out with a program recently in which they are waiving surrender charges on the new variable product when funds are rolled over from the existing fixed product. And they're paying an asset-based commission on that as well. I think that's an innovative approach. It certainly helps the consumer. Based on Tim's concerns about the profit margin on this product to begin with, it seems to me that would probably lead to decreased profits in the future for the life company.

From the Floor: I know on the life insurance side, especially some activities going on in New York State, the regulators are looking to improve and strengthen replacement regulations including prohibiting any kind of favorable treatment on replacements. Waiving the surrender charge on the existing business in order for it to come over to a new policy, or doing something better on the new policy that if it's issued as part of an exchange program as opposed to something issued brand new, might be prohibited in the future. Depending on where that kind of activity goes, it may affect these kinds of exchange programs that you were describing.

Mr. Milton: Well that's interesting. I appreciate the comment.

From the Floor: We've gotten some feedback from the market regulators that they didn't appreciate this. They were concerned mostly about fairness issues. We've backed off from this. We're waiting for more guidance on this issue before we do this kind of thing. A whole different set of regulators are looking at that.

Mr. Theodore: In terms of differentiating in the marketplace, if everyone's moving toward external fund managers, how do people differentiate themselves in the marketplace?

Ms. Kenneally: Well, I think one way is through the variety of funds that are being offered. Companies are coming out with lifestyle funds, small cap funds, and just all kinds of new and different types of funds. There's also service features such as dollar-cost averaging, automatic account rebalancing, 800 servicing numbers, and things like that.