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Session 11PD
Variable Products—Pricing Issues

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Moderator: NANCY M. KENNEALLY
Panelists: TIMOTHY J. RUARK
DANIEL THEODORE
Recorder: NANCY M. KENNEALLY

Summary: In this session, the panel addressed major issues relating to variable products (including life and annuities). These issues are:

- *pricing & design issues*
  - *GMDB*
  - *GMIB*
  - SPVL
- *living within your expense margins*
  - *variable product administration*
  - *is variable business more expensive to administer than nonvariable business?*
  - *are new customer-based technologies cost efficient?*
- *impact of the new SEC law on product design*

Ms. Nancy M. Kenneally: Variable products, both life and annuities, continue to enjoy considerable growth in sales. If sales continue at their current levels, we can probably expect to see variable life (VL) sales reaching $3.2 billion for the year and variable annuity (VA) sales reaching $80 billion for the year. For variable life sales, this is relatively flat over last year, but represents an approximate 9% growth rate in VA sales.

VL sales are still representing roughly 25% of all individual life sales and sales are, no doubt, fueled partially by the phenomenal stock market returns that we've seen lately. We've seen these returns also in the mutual funds that are backing the

VA and VL products. The net-weighted average, one-year return for the year ending June 30 was roughly 19% for the funds backing both life and annuity products compared to the Standard and Poor's (S&P) 500 for the same time period, which was 35%. The five-year return, net-weighted average for all funds backing life and annuity products was approximately 14% compared to the S&P 500 of 20%.

In our session, we will cover three pricing related issues for variable products. First, we'll hear from Tim Ruark who will discuss some pricing design issues related to Guaranteed Minimum Death Benefit (GMDB) and Guaranteed Minimum Income Benefit (GMIB). Then we'll hear from Dan Theodore who's going to talk about administration and expense margins. Then I will speak about the impact of the 1996 amendment to the Investment Company Act and the impact on the variable life product design.

Tim Ruark joined CIGNA Corporation's Actuarial Development Program in 1983. He received his Fellowship in the Society of Actuaries (FSA) in 1988. He has had a broad range of assignments at CIGNA, including duties in the company's individual insurance: CIGNA Health Care, CIGNA Retirement Services and, most notably, CIGNA Reinsurance. In his current assignment in reinsurance, Tim is charged with building nontraditional reinsurance programs. Tim has led his company's effort in developing risk management programs for variable annuity death benefits, equity-indexed products, reverse mortgages, stop loss, and others. Tim is a math and physics graduate of Brown University, a native of Westling, Michigan, and now resides in Connecticut with his wife and daughter.

Dan Theodore is a consulting actuary in the New York office of Milliman and Robertson. Dan consults on product development of life insurance and annuities as well as New York and SEC compliance issues. Recent assignments have included market conduct lawsuit settlements, Internal Revenue Code (IRC) Section 7702 compliance, and reinsurance. Prior to joining Milliman & Robertson (M&R), Dan had more than 14 years of actuarial experience in the life insurance industry. Dan is an FSA, a Member of the American Academy of Actuaries (MAAA), a Chartered Life Underwriter (CLU), and a Chartered Financial Consultant (CFC). He has spoken at meetings of the Society of Actuaries (SOA) and the Actuarial Society of Greater New York. He graduated with a bachelor of science degree in mathematics from Binghamton University.

I'm a consulting actuary with Tillinghast-Towers Perrin in the New York office. I've been with Tillinghast for about two years, working mainly in product development for VL and VA products. Prior to that, I worked for six years at The New England, also in product development and product management of nontraditional products.

Mr. Timothy J. Ruark: We are going to chat about pricing issues. The issues that I've chosen to talk about are ones that I think are important enough that companies need to have a position on them. I'm going to focus, as Nancy said, on design issues, so these are product elements that I think are important. I'm going to try to draw some sort of an argument that explains why these design features have popped up in variable products. Many of them weren't there five years ago, so why are they there now?

I'm going to talk about four things, one of which is GMDB. GMIB will be the second topic, and the third is the VA floor, also known as a variable annuity maturity benefit (VAMB). The fourth is single premium variable life. When I put this presentation together, images of beasts came to mind. That's the theme I'm going to use.

The GMDB has a significant pricing implication. Years ago, of course, it was just a return of premium death benefit. What you're trying to do for the consumer is give them some assurance that, under certain conditions, they will have some guarantees in a product that, otherwise, has very few guarantees.

The guarantee here relates to someone dying. The idea is that if you give the person a guarantee that death proceeds will be given to their beneficiary, that might help the sales process for some customers, such as people who aren't as comfortable with variable products. So that's kind of the origin of it.

As VA started to flourish, and many companies got out there with designs, it became very difficult to differentiate your product from somebody else's and, for whatever reason, the GMDB became a point of differentiation. It was very easy to say or to attempt to explain that. My product is not a return of premium; it's a seven-year ratchet. You could go through a process of explaining that to the consumer and they could see that it is different. They would struggle often with knowing why the investment fund managed by ABC Company is that different than the one managed by XYZ Company because they both said that they're growth and income funds. Consumers struggled with that, especially, consumers that were not accustomed to variable products.

A simple illustration of this would show that if your account value is $1,200 and your GMDB is $1,200, and if there is a correction on January 1, and it takes your account value down to a $1,000, you've guaranteed the owner of that annuity that if they were to die, their beneficiaries will get the full $1,200. That's the GMDB. So you're going to get $1,000 of that from their account value. You've got to come up with the extra $200, because of the fund performance.

Now that's a big deal actually when it gets down to price. You have a $200 exposure or net amount of risk. If you use a 1% mortality factor, then what would you expect if that market corrected January 1 and stayed flat for the whole year such that those values remain constant. You'd expect $2 of mortality on that case. Of course, $2 doesn't sound like very much now. If your account value is $1,000 for the whole year, then, of course, ten basis points is just $1 so $2 must be 20 basis points. So this $2 of claims has created an additional risk or additional cost of 20 basis points. Even a simple example reinforces how material this stuff is. At the same time, it's not one of the design features that you can just get rid of. It may have seemed silly a few years ago, that people would buy a VA based on a death benefit. The reality today is that it's important. It's not something that you can give away or get rid of; it's there in your product.

I'm not going to go into a lot of detail on the GMDB. For those of you that are not familiar with it, I will just leave you with the idea that the return of premium was just the beginning. There are things that are much more complicated, and much more costly than that type of benefit, so there are significant pricing issues there. As far as this piece goes, it's similar to a catastrophic type of coverage or stop-loss coverage. I use an analogy of entering a nightmare in which you're going down a corridor and there are 100 doors, and 99 of them have something good behind them and one has something really bad which is the beast in this case. You open that door and it's the CFO looking at you. That's the risk.

I gave a simple example of losing 20 basis points. That was less than a 20% correction. What if it was a 30% or 40% correction? What if it stayed for longer than a year? That's why this is a very serious type of benefit. But there are ways to handle the risk, which I'm going to go into.

One thing that may give you some comfort is if you have poor investment returns that create high exposures it may be that you'll have high lapses. People won't hang around to die. It could happen. Not all your funds are correlated. This isn't just a stock program. There are other types of investments involved, and they will not always move in the same direction. You can certainly purchase puts that will protect you from, for instance, the S&P going down. Most of the products have designs that limit old age exposures and that's a design element to just make sure that when the people with very elevated mortality get to where they can really hurt you, you have some restrictions in your plan. Then their deaths are not as problematic as some of the younger folks. Maybe mortality will continue to improve.

I've heard this one which isn't good at all. It's not a problem to you because it's reinsured. That's true I guess, but I assure you that the design elements of your plan

are reflected in the reinsurance price. I know what my company reinsures and I am pretty confident that the other companies do too. It's an item where you can get away from the volatility by reinsuring, but it still should't keep you from designing your product wisely.

Let's move on to a new beast—the GMIB beast. Most noteworthy right now is The Equitable, which has a design very similar to the GMDB except you don't have to die. However, you can't annuitize right away. You have to wait a certain number of years before you can annuitize. The guarantee says that at time equals zero, when you're selling the plan, you can tell the consumer that no matter what happens with the funds, you're guaranteed a certain monthly amount if you choose to annuitize after seven or eight years. So it's a strong guarantee in that you're telling somebody that they have the option to elect this. It's not like death which is involuntary. They have the option and you're creating that optionality for them. That's always something to be wary of. True, it deals with annuitization. I use a figure of less than 0.5% per year of people annuitized. Will this design be a product that will encourage annuitization? That could be, and there are many assets out there in the deferred stage that many companies would like to retain, perhaps even through annuitization, so it's a benefit to be reckoned with. It could be something that becomes as commonplace as the GMDB.

It creates a new story. Again, the people who sell VA are often brokers. They have a very simple story, and they often have a dozen companies that are trying to get them to sell their product. They have a hard time, as professionals, understanding which one to promote to which customer. One thing that the GMIB has done is it has given the sales people, the brokers, a very clear reason to promote one product. It has something that the others don't have, so it's a story. Actuaries are often uncomfortable with this, but a story is really very important in the marketplace where people are selling these products. There must be something very simple that you can tell your consumer. You can argue about whether the GMIB is simple, but it can be simple.

Let's take an example. The account value goes down. Somebody gets to the point of annunitization, and you must have the full amount of money, because you've made a guarantee of monthly income. There are some important differences though and they impact price. It's not as path dependent as GMDB. Regarding GMDB and mortality type of coverages, if fund performance is down and somebody dies, there's a benefit paid. As I said, you often must have the contract in place for a number of years before you can get a hold of the GMIB benefit. So it doesn't really matter if your funds go down for three or four years. As long as they're up when it's time to honor this guarantee, you could be fine.

Interest rates are very important. When somebody annuitizes, they annuitize on your paper. You have the potential to gain from annuitization. Of course, anyone that has spent some time with purchase rates, immediate annuities, guaranteed purchase rates, and VA knows that they tend to be conservative. To the extent your GMIB works off of those conservative purchase rates, then interest rates are also important to you. When that person chooses to annuitize, it's not like a death where, within a few days, you need to mail out a lump-sum check. You're going to make monthly payments. Even though their account value may be less than the guaranteed amount, it may be that the interest rate environment creates the extra windfall that you need to fund the monthly payments. So it's a little bit different than the GMDB. It has that extra level.

The GMDB combined with the GMIB might actually create a better risk profile. In simple terms, you're giving somebody two things that are valuable. Hopefully, you're charging for both of those items; somebody will either die or annuitize, but not both. They shouldn't be able to and so it's a case where maybe there's a little bit of natural hedging. Also, some of you may also see something in the interest rates. Today it's very common to say that if interest rates go up, stock prices will go down and vice versa. Now that's not always true, but certainly that is the popular opinion. There does seem to be evidence of some correlation. Obviously, for this product, if funds are doing poorly because stocks are doing poorly, and if high interest rates are the cause, that may give you the protection you need on the annuitization piece because those high interest rates allow you to invest the proceeds to fund the monthly payments in the future. So it's a different item than the GMDB. There are some similarities, but they are definitely different.

Let's discuss the VA floor. Like in the GMIB, it gives somebody a valuable guarantee that doesn't relate to death. They don't have to die to get the benefit. Living benefits are very important in our current business, and this tries to get at those living benefits. What you offer does not require annuitization. For example, let's say that ten years from now, no matter how the funds perform, we guarantee you that we will return your premium to you. If you want to get out after ten years, we'll give you back your premium. Now there are a few moving parts already, and there are not many of these products on the street. But if you didn't want to do ten years, you could do five years, six years, 20 years, or whatever. If you didn't want to say, "You're going to have your premium," you could say, "We'll guarantee you 110% of your premium, or we'll guarantee 90% of your premium, so there are other ways to design this. They all have a cost.

A key here is that VA writers are very protective of the turf. It's getting more and more competitive. You certainly don't want to lose what you already have. At the same time, VA writers are always getting hit from the mutual fund industry, and one

approach to combating the mutual fund industry is to make it very, very clear to the media and to the public that a VA is not a mutual fund. I know we do our best to tell that right now, but the media doesn't pick up on it. Perhaps it is because some of the things that we think are important, like the options we give people to annuitize, or the commitments that we will pay a monthly income 70 years from now, kind of go over the heads of most people. They don't think these things are as valuable as we do, so the direct comparison is with mutual funds.

Perhaps by including a lot more guarantees, like GMDBs, GMIBs, and VA floors, you can start to really demonstrate that this is an entirely different animal than a mutual fund. VA floors are rewarded for good behavior. If you don't hang around for *x* number of years, you don't get the guarantee. Maybe that would help with some of the persistency, especially as you near the end of the surrender charge period. I've already given you my simple little illustration.

Dollar-cost averaging may be helpful for this product. Generally, these floors are backed by index funds and so you don't have some of the fund diversification that you get with the GMDBs and GMIBs. If stocks go down, bonds might go up. So you're really kind of connected to the S&P on this product, for which you must think about buying derivatives because the risks are huge. Somebody in Washington said, "Billion here, billion there; pretty soon you're talking about real money." Does anybody know who said that?

From the Floor: The late Everett Dirksen.

Mr. Ruark: See what that did to him. So that is the case here. Remember the 1% mortality rate meant your risk was $2 for the GMDB. For this product your risk is $200, and all you have to do is live to the end of the time period. I know that's not possible for some of the demographics that we deal with, but 85% or 90% of your people will persist, so there's a lot of money at stake here. So derivative protection may be very important, although, as some of you know, derivative costs are very high on today's equity-indexed side. Equity indexes generally require call options. These are put options, but they're all options. Wall Street always wants to make money and it's relatively expensive. As you talk about this whole group of baby boomers coming in, you realize that some of them have never invested before. You want to get them into variable products and tell them, "If you're patient and willing to wait it out, you're not going to lose money on this product."

I want to wrap up by discussing a single premium VL. The wrong people are selling VL. Most of the VA growth has been fueled by the brokerage community and people who know how to sell equities. That hasn't been the case with VL. The changes that we are seeing to single premium variable life is an attempt to mimic

some of the patterns that have made VA sales so successful. Much of that relates to asset-based charges.

There is more focus on underwriting, but try not to be too heavy-handed on underwriting. If you go to asset based charges, and asset based cost of insurances (COIs) instead of net amount of risk-based COIs, it's the same kind of stuff I've been talking about on the annuity side. It's where you were making a guarantee. If the funds do well, you're fine, but if the funds do poorly, you could lose a lot of money. Not only won't you collect as much money for the risk, but you get more and more exposure—so it's a double hit. This is not without risk. It sounds great in that we could equip the brokerage community or others to sell life insurance just like they've sold VA. We'll use some of those same tactics, but it's not without risk. So this is another one of the beasts.

What I want you to remember is that customers do seem to want packaging. They want the upside potential, but they want guarantees. It used to be that the perspective of the insurance industry was that you can have one or you can have the other and you choose. It is not that focused on the customer. The products that I've talked about for various reasons are what the customer wants. The challenge becomes how do you create that for them? As a group, actuaries are well paid. We're comfortable, and we're pretty good at investing. I think we all can still appreciate the real value in products that do provide an upside potential—there is some type of floor or some type of guarantee that things can't go that bad. There is a big market out there.

You have to get out of your zone. Things come with risk and, yes, they could go bad, but not everything can go bad at once, can it? Beware! When we talked about the death benefit, we discussed $2. It seems like such a small amount, but when you multiply it by thousands, tens of thousands, or hundreds of thousands of contracts, it's a real beast.

Mr. Daniel Theodore: I'm going to talk about variable product administration, and what it costs. I think I'll just start off by reviewing some of the issues that you'll have to resolve in the process of going to market with variable products.

The first issue that you're going to have to decide is, who's going to sell your product? Many questions come up regarding administration costs. Compliance costs are being discussed at another session. If you're going to be using your own company's retained field for it, it will be necessary to ensure that your agents are registered. You'll have to set-up an office internally to keep track of the registration, to keep track of making sure the policies don't get issued with selling agents who aren't registered at the time of sale. I know that sometimes agents would like to sell

a case before they're licensed and have the commission changed over to them once they are licensed, but that's not acceptable in the variable marketplace.

You'll have to determine at what level you'll have principals in the field office. Will you have them in each individual field office where records are kept on a centralized basis in the field, or will they be kept in the home office. Is the company going to be comfortable with dual licensing of the agents and the liabilities that it creates for you if your own agents sell products that aren't your own products. If you use an external distribution network, are you going through a wholesaler or to an independent broker/dealer? How much are they taking for that cost? In your home office you'll need trained customer service personnel to handle policyholder calls, issue policies, answer questions, and execute policyholder requests.

Will you be providing internal investment options managed by your investment department? This decision is colored by the investment histories of your own investment options. Must you put more seed money into these funds, and are you going to be able to control expenses enough within these funds to actually generate a profit off your advisory fees? How long will it take to get the seed money out or to make these profits.

If you use external advisors for their histories and for the name recognition, it's unlikely that they're going to be willing to part with any of their advisory fees. This is one of the sources in profit margins in your product, so it's one place where you won't have an opportunity to make profit, except perhaps off of fixed accounts.

As I said, you're going to run into compliance expenses in-house, in the home office and out in the field. In the home office, you'll have to register people who deal with the customers or at least their supervisor. You'll have to review suitability of your customers for purchasing these products and someone in the home office has to review that part of the application and sign off on each one, if only on a mechanical basis. There is a responsibility there. A prospectus of your policies will need to be updated annually and refiled with the SEC.

Finally, we're going to get to the big one, systems resources. This is an area that has changed dramatically in a very few years and the cost structures have changed equally. VL could never have come about without the computer capabilities of our advanced mainframes. Up until the 1980s all computer applications were done on a centralized mainframe. Users accessed that mainframe through dumb terminals on a time-share basis and all functions were centralized. This provided a central database that was necessary for insurance operations and was required by the company, but was also characterized by very high overhead costs and by

overloading the system, which occurred when everyone tended to use the system at the same time and make common demands. Systems had rigid input and output limitations.

In the 1980s, personal computers (PCs) dominated individual use. The flexibility that these PCs provided was powerful for agent sales presentations and PCs could support graphic intensive input and output, but distribution was difficult to handle. You had to send out individual disks to individual agents. Keeping software up to date and controlling who had your software was nearly impossible. The PCs could be used for sales and support, but rarely for administration. Occasionally, it could be used for very small blocks of business or for special functions that you wouldn't bother implementing on the mainframe.

The maturity of the network server model is reflected not only in the widespread access to the Internet, but also in insurance sales and administration systems that operate in the PC environment; this allows multiple users and multiple applications. Networks combine flexibility and graphics to PC systems that puts much of the processing at the location of the end user, but there is access to a centralized database with shared data and resources, similar to a mainframe system. This is all done at a much lower overhead cost. The availability of these systems provide easy communication among underwriting systems, in-force management, and in-force illustration systems. It can all be linked together.

If you're going to get up and running you're going to have decide whether you are going to administer this product in your own offices. If you choose to build your own systems, they'll be customized to your company's needs and be integrated with the existing system so that you will be able to do client databases better. One of the best reasons to do this is so that you spread the overhead of your mainframe systems (your systems department and your programmers) over more product, so that you're making additional sales on which your existing overhead can be spread. There are tremendous costs in internal overhead and internal resources and, unfortunately, internal projects seem to rarely come in on time or under budget.

You can choose to license one of the many ready-made systems, many of them are now operating on these network servers. This gives you an advantage of lower starting costs and all the advantages of the network model—the flexibility to add new plans, new benefits, new provisions, and new products on a rapid basis. However, you run into the problem of choosing to spend the money to integrate these systems with your existing plans and your existing systems. If you go without that integration, in the long run, you encounter problems keeping track of compensation, policyholder records, and reinsurance valuations.

Finally, you can go outside the company to relieve the home office of the internal demands on these resources. Some companies have gone as far as to spin off their administrative and systems areas and into separate, independent companies. Some of these companies even buy the computers from the home office and are, hopefully, going to provide administration services on an efficient basis because they actually have to answer to making estimates and making a profit on their own. Other companies have turned to third-party administrators (TPAs) to administer their products.

Advantages here are the opportunity to bring out a product quickly because systems are already in place to administer these products. You can gain from their experience in what sells and what works and doesn't work administratively. You gain from having fixed costs. You know up front what it's going to cost to administer a product with the third party administrator. In that you trade off the ability of achieving cost savings as you achieve critical mass, unless you can ultimately bring it in-house. There you'll have to have an open end in the contract to recapture the administrative capabilities if it's desirable. Also, if you go to a third party administrator, you may be limited in design to the product variation they're capable of providing or, again, raising the cost of providing it. Again, it's difficult to integrate third party administration services with your home office systems and home office services. Finally, if they haven't gotten scared off, you can just go sell someone else's products and that keeps you out of it. You can share the risk, the reinsurance and, hopefully, profit through that.

When you're selecting a system or designing a system, unfortunately, there are many issues you'll have to deal with and many levels of processing that occur. On the policy level, you'll be deducting M&E charges from the separate account and transferring money to the selected investment options at the end of the free look period for these individual policies. On demand you'll be purchasing units based on premium inflow and making transfers among accounts. On the entire in-force block, you'll have to deal with both purchase and redemption of units after the input of unit values and with situations where transactions must be undone or redone. For instance, more often than not, data are input incorrectly or records are mistimed. It's important to be able to back up a series of events and bring them forward again. For instance, if unit values were incorrectly input, and if it's not discovered for a day or two days or if a policy premium gets lost in the home office, you must be able to correct them as of the date they happened. So building a system in advance to anticipate that is going to be very important.

Does it cost more to administer variable products? I think we know that it's going to cost more. Hopefully, we'll achieve a combination of efficient systems and economies of scale by sharing administration bells and whistles among different

products and having a growing block of business that will reduce unit costs and generate profits.

Where might we make these profits? The sources of profits from variable products have traditionally been in the cost-of-insurance deductions. In recent years, the trend has been narrow though, particularly, in the later durations where there are even reverse, select-and-ultimate, cost-of-insurance deductions. I think some of us may be secretly hoping that population mortality improvements will generate real margins there sometime in the future. For the moment, we're pricing with very little margin in the future.

M&E charges are probably the greatest source of profit, and I've always thought of that as the defined source of profit because that's the risk an insurance company takes when it sells a variable product and until it makes the profit on that risk. But we're tending to give that away in the later durations through reduced M&E charges in later durations, done either directly or through negative cost-of-insurance deductions and other persistency bonuses. We may be making it off the advisory fees on our investment funds or off the spreads of our fixed accounts, but we're tending to give that away because we're using outside advisors. Finally, if these products are so expensive to administer maybe we're making them off the loads and administrative charges or maybe we are not.

In October 1996, the National Association of Variable Annuities (NAVA) released a study of VA expenses for the 1994–95 calendar year. The data for administrative general expenses reflected 63% in 1994 and 59% in 1995 of industry assets, excluding TIAA. In terms of sales volume, expenses reflected 59% and 58% of sales volume. So this reflects a substantial portion of the assets of the industry.

During the period from 1994 to 1995, overall expenses dropped from 52 basis points to 39 basis points as a percentage of average annual assets. Some of this is explained in that there is a different mix of companies from one year to the next and NAVAbelieved that there was more accurate reporting in the later years. I think we can also see a very clear connection between the assets in force and the expenses associated with them. They start as high as over 1% of assets for companies that are less than one billion and then drop down to 36 basis points for companies that are over the $10 billion mark. I think it should be noted that the smaller companies are those with the smaller asset bases. They grow and reach critical mass which appears to be $1 billion. Their expenses seem to drop precipitously.

When turning to sales expenses, on the other side, we don't see as broad a range. Sales expenses have risen over the same period, and perhaps that reflects a more competitive market environment and that it is taking a little more service to the field

and to the clients to get these products sold anymore. We see that volume does relate less directly to size, though there is apparently a much higher cost associated. It might have been $100–500 million. In 1995, it's more like the $100 million mark. It looks like the critical mass falls somewhere between $100 and $500 million to achieve some levels of efficiency.

Some of the other issues that are going to come into your pricing are what type of products are out there and how many products you're going to put on these systems. Are you going to be introducing VA, variable universal life (VUL), a hybrid, fixed premium VUL, last survivor variable, single premium variable, group variable universal life, corporate-owned life insurance (COLI), bank-owned life insurance (BOLI), and first-to-die policies? I don't know if anyone has these yet. We've already heard about GMDB and GMIB. Some companies offer the agent a choice of how they will be compensated for the sales. Unfortunately, this may offer some antiselection risk up to those agents who anticipate short-term stays. They go for a heavily front-loaded compensation and this will be a difficult thing to control. It is hoped that by designing your compensation properly, it might give you this opportunity. Again, this is a chance to lure more agents.

Market-valued-adjusted investment options, and maybe even equity-indexed options may be in the future. Portfolio asset rebalancing, dollar-cost averaging, minimum distribution, and systematic withdrawal programs are common, particularly if you're selling inside an Individual Retirement Account (IRA) market, where, beginning at 70½, people must take withdrawals. Maybe they don't want to annuitize. Maybe they want to take a series of withdrawals that preserve the principal.

The services are becoming more expensive to provide, though the technology is helping to make them easier. Other businesses are offering advanced systems and the insurance industry must step up to the plate for this one and provide 800 numbers. I don't mean 800 numbers that are there from just nine to five, but 800 numbers that are there 24 hours a day. They should not just provide today's market value or today's unit cost, but they should also allow me to take advantage of the same sort of transfers I might be able to do on a telephone line. Will I be able to get directly not only today's unit value and performance figures, but also numbers that compare the industry average to the S&P 500? I think people want to know how they're doing relative to common indices. As banks get into this business, will they be providing these benefits and the opportunity to make transfers and so forth on automatic teller machines (ATMs)? If you're going to support multiple distribution outlets, that's going to cost more money. You're going to have to plan for the different compliance, and compensation, and even services that each distribution

outlet is going to demand, whether you use a captive field force, independent agents, stockbrokers, banks, or the Internet as the future.

Finally, something coming in the future, as we've already heard, is immediate annuity benefits. We're hoping that will be a growing benefit. I know some companies are starting to look at providing immediate annuities that do have partial surrender benefits that don't just surrender the fixed period up front and defer the rest. Level compensation with trailers is probably going to become more prevalent, particularly now that New York is starting to think about that. That will affect New York probably more than anyone else. Equity-indexed investment options may become part of VA rather than being stand-alone products as people become more sensitive to the guarantees. You're talking about offering that on the whole policy. It may be done inside specific options instead. Companies are already offering the GMDB as a stand-alone benefit on mutual funds. Similarly, the GMIB may also be something to be looked at there. But we will see companies selling GMDBs and disability income to attach to other types of assets and these are opportunities for insurance companies to create synergy with other types of distributors and other types of products. More companies will be competing in this area. We're going to see banks and other financial institutions selling this. We will need to be distinguishable by the services we provide and by the benefits we provide, but the trick will be to provide these benefits and services at a competitive price and on a cost-effective basis.

Ms. Kenneally: My topic is the impact of the Investment Company Act Amendment of 1996 on VL product design. I'm briefly going to go through what I'm going to refer to as the "old rules" of the SEC regulation, then onto what the new rules are, also, known as the Reasonableness Standard. Then we'll take a look at what the or industry response has been to this new standard.

I'm sure anyone who has had anything to do with product development or product design on the VL product side, is familiar with the old or previous SEC regulations with respect to limits on product charges and sales loads. Since they are just that, old rules, I won't spend too much time going through them, but I thought it would be helpful to quickly go through them just to compare what we've come from to see what we're going to.

Product design for variable products, VL products in particular, was greatly influenced by the old regulations. Because of the abundance of rules and regulations and limits in the previous SEC regulation, products within the industry look fairly similar. As we know, administrative charges had to be cost based and the prospectus had to state, basically, that charges were reasonable and that the insurer didn't expect to profit from these administrative charges. The M&E risk

charge also needed to be reasonable in relation to the risks assumed or within industry practice. We had to essentially put the artificial limits of 60 basis points and 90 basis for fixed premium and flexible premium VL products respectivley. Maximum cost of insurance charges were 1980 Commissioners Standard Ordinary (CSO). Although there's no SEC restriction on asset-based cost-of-insurance charges, they must fall within the cap of the1980 CSO table as well.

The charge for premium tax must be cost justified. It was possible to deduct either a flat rate across all states, which is administratively easier for most companies, or to actually impose a state-specific premium tax rate. Deferred acquisition cost (DAC) tax deductions, on the other hand, were considered sales loads unless companies went back and obtained exemptive relief from the SEC in order to allow them to charge a specific load for DAC tax; here again, it needs to be cost justified.

All other charges and loads within the products are considered sales loads. And we have an abundance of complicated limits on what the sales loads can be. Generally, there's an overall 9% of premium limit on sales loads measured over the lesser of 20 years and life expectancy. We have a maximum first-year load of 50% which could, in some cases, trigger the refund sales limit. And then we have the added constraint that loads cannot increase with duration.

So now we come to the new Reasonableness Standard. Just about a year ago, at the beginning of October 1995, President Clinton signed into law the National Securities Markets Improvement Act of 1996. This gave a sweeping revision to federal securities laws. The most significant provision of the bill for life insurers that issue VL and variable annuity products are the changes to the Investment Company Act of 1940 which regulates variable products.

The new regulation essentially eliminates all of the prior regulatory framework on variable life sales loads and charges. Sales loads are no longer subject to the overall 9% limit. Administration charges no longer need to be cost-based, and there's no longer any artificial limit on M&E charges.

But what does the new standard give us? The new regulation imposes what has been called a reasonableness standard, and this says that aggregate fees and charges must be reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurer. To ensure that this new reasonableness standard is taken seriously, the regulation has a new disclosure requirement which is that the contract's registration statement must state that the contract complies with this reasonableness standard and that the aggregate fees and charges meet this reasonable test.

Now this new regulation does give us some new flexibility in designing VL products. With the elimination of all of the sales limits and charge structures, we can simplify the product structure. There's no more refund sales limit or cap on surrender charges. This may provide better expense recovery where we can better match our expenses incurred to the loads that we charge through the product. Eliminating surrender charge gaps and sales loads units could mean that products no longer have losses due to lapses in the first two policy years, which is an issue that companies currently struggle with. Then, because of the ilimination of the cap in the first two years and of the sales refund limit, there would no longer be the steep increase in the surrender charge that we currently see in some products in the third year.

The new flexibility also extends itself to simplifying face increases. There are no more limits on the various charges and sales limits that you need to currently do for face increases. Because your expenses and charges can be better matched, you may be able to eliminate commission chargebacks that are common in some products in the first year. The regulation also eliminates the 24-month exchange requirement, although this requirement is still going to be required by some states. It also eliminates the need for filing for exemptive relief, such as, the DAC tax exemptive relief that I mentioned earlier, which may shorten filing time and, hopefully, cost.

But insurers now face the challenge of determining how to meet this reasonableness standard or the reasonableness test. Unfortunately, the legislation provides very little guidance about how to apply this reasonableness test. Although we've been given a new level of flexibility, there are many unanswered questions.

There are three main questions that have been left open. One is we're required to make this disclosure statement, but where? We've been told that it needs to go into the Registration Statement, but does that mean Part Two of the Registration Statement, or does that mean it should go into the prospectus where the consumer can see it? We're meant to be analyzing our charges and expenses to determine that they're reasonable, but on what basis? The question also arises as to whether aggregate fees and charges include investment advisory fees?

What we did is we went to the industry, basically, and conducted a survey to assess how companies are interpreting these issues. We've surveyed the participants in our Tillinghast Valve Survey which is the variable annunity and Life User Exchange Survey. We surveyed approximately 45 companies and we received responses from 29. These 29 companies represent roughly two-thirds of the VL premium written. We focused on two areas: one, how do companies plan to comply with the

reasonableness standard; and, two, do companies intend to change their VUL products in order to comply?

So our first question was where do companies plan to include this required disclosure statement? We gave them a choice of Part Two of the Registration Statement, the prospectus, or somewhere else. The majority of the companies said that they planned to put it in Part Two of the Registration Statement. One company plans to put the statement in their prospectus. One company plans to keep it on file in the home office, which is probably not what the SEC intended. What is interesting to note is that 31% of the respondents said that they didn't know yet where they were going to put this statement.

We asked companies how they planned to analyze their expenses. Do they plan to analyze their actual company expenses to determine whether or not they're reasonable, or are they going to look at industry averages to determine whether their company expenses are reasonable. Will they look at both, or is there any other source that they would look at. Roughly half of the companies responded that they would look at their own company expenses in relation to their total company expenses to determine reasonableness. One or two companies came back and said that they would look at their expenses versus industry average expenses. About 20% said that they would look at both company expenses and the industry average. We have a large proportion of companies, 30% who are saying they haven't yet decided, and they're not sure how they're going to analyze their expenses.

From the Floor: Are these percentages of premium or percentages of companies.

Ms. Kenneally: These are percentage of companies. It is the percentage of the 29 participant companies. Our next question was, do companies plan to include investment advisory fees when they're determining reasonableness? Have they interpreted the SEC's regulation that aggregate fees and charges include investment advisory fees? We see that approximately 50%, or half of the companies said, yes, they do intend to include advisory fees in determining reasonableness. A quarter or so of the companies said, no, they don't think that's how it should be interpreted. Another large portion, about 25% of companies, said they hadn't yet decided.

Companies may need to make the statement that fees and charges are reasonable in the aggregate, but we asked companies how they plan to analyze their loads and charges whether they intended to look at them by categories as they currently are in their products or if they intended to look at them in the aggregate. Roughly half of the companies, 45%, said that they would not analyze their charges separately. Thirty-four percent said they would analyze them separately by category. About

20% of the companies said they weren't sure, and that they didn't know how they were going to do that yet.

Our last question was with respect to whether or not companies were changing or intending to change their product in order to comply with this new standard. The majority, (close to 60% of the companies) said they didn't need to change their product in order to comply. One company did say that they intended to change their product. An overwhelming 40% said they weren't sure whether they were going to change their products in order to comply.

So what we can see from these results is the regulation does provide a new level of flexibility in designing products; however, companies are still unsure of how to interpret some of these issues. In that respect, they're not running out and redesigning their product. They are taking a wait-and-see approach, to see what other companies are doing. It is likely that the trend to change product design will happen more gradually as products get to the end of their product life cycle and need to start being repriced. That's probably when companies will take advantage of this new flexibility in changing their charging structure. We might expect to see charge structures become less unbundled and looking more similar to company's UL products as opposed to segmenting all of the loads as they are currently.

Ms. Ann M. Delaney: You have said that the 1996 Act virtually eliminated all limits on sales loads. Does that include the SEC Guidelines. There will be no more need for refund of sales loads?

Ms. Kenneally: That's right.

From the Floor: A question about the performance of the stock market. If we do have a prolonged downturn, how will that affect sales?

Mr. Ruark: When the stock market corrects, people will buy low. Many people will move money at perhaps a bad time, which isn't very good. But I think some of the comments that I would make is some of the alternative products that we've been hearing about may find that a correction is what they need to start getting noticed. There's a feeling with equity-indexed companies that this might actually be helpful. Some segment of the population sees that investing in a VA is not a free lunch. It's not always going to go up. Maybe an equity index that has a certain guarantee would be helpful. If that's true, then there's a portion of the population that would go for the product that I talked about, the VA floor, which is a way to reassure a lot of investors.

From the Floor: One of the issues is that these features that make the product attractive to the consumer are usually more expensive. At some point, the added cost will make the feature less attractive. Does anyone have a sense of how much the consumer is willing to pay for these guarantees? At which point do guarantees become too expensive and make the product less attractive as a result of those charges?

Mr. Ruark: I think we have to be careful that we don't have one consumer out there. There are millions and millions of consumers and sometimes you're just after a certain niche. I personally thought the GMIB that's out there right now (The Equitable product) would not create the type of attention that it has. I think their charge is an extra 25 basis points. It might not be worth it in your opinion. Yet so many companies are now clamoring to have the GMIB because it has created a story and people are willing to pay for it.

The other product I chatted about, the VA Floor, is very expensive. That also can be funded through asset-based charges. I've seen charges for that product—there's certainly charges and prospectuses that are 200 basis points, allowing the company to charge an additional 200 basis points for that protection. Now part of that is that the companies have to protect themselves from future changes in the capital markets and perhaps higher derivative costs. They don't want to have to refile, so they've built in something that appears to be way out there. There are design elements in that product. A ten-year guarantee on the VA floor is much cheaper than a five-year guarantee, so there's a way to get at the design that way.

I think you raise a good point. There must be a point where certain consumers are saying, "No more, that's too much, I'm not willing to pay it." I must caution you actuaries who are sophisticated financial people. We tend to think, why would I buy any of these guaranteed products. I can take the risk of a VA. I have a 15-year time horizon. What's the big deal? We are not the target market for most products in the universe.