**RECORD, Volume 24, No. 3***

New York Annual Meeting
October 18–21, 1998

# Session 102OF
# Titanic of Product Development: Avoiding the Iceberg

**Track:** Product Development
**Key Word:** Insurance

**Moderator:** BRIAN G. KING
**Panelists:** NORSE N. BLAZZARD†
KEVIN A. MARTI
**Recorder:** BRIAN G. KING

*Summary: This panel briefly:*
- *Discusses the unique problems of product development in small insurance companies*
- *Considers the value of turnkey products, reinsurers, and other expert services*
- *Shares insights on the ability of smaller companies to offer "luxury" products (e.g. equity-indexed or variable products)*
- *Discuss the role of changes in technology*

*Panelists explore various issues in product development through the metaphor of the ill-fated ocean cruiser and initiate audience participation through public dialogue on the topic.*

**Mr. Brian G. King:** I will be serving as moderator for this session. Our panelists are Norse Blazzard and Kevin Marti. Norse is a principal at the law firm of Blazzard, Gradd and Hasenaver, P.C. His firm specializes in the development and regulatory clearance of insurance products and mutual funds for the financial industry. He has more than 30 years of experience in the variable annuity and variable life insurance business. He is a founder and past chair of the trade association for variable products industry, the National Association for Variable Annuities, where he currently serves on the board of directors and as the chair of the Variable Life Insurance Committee. His firm is also counsel to the association. He is a 1998 inductee into the John D. Marsh Memorial Variable Annuity Hall of Fame. He

*Copyright © 1999, Society of Actuaries

†Mr. Blazzard, not a member of the sponsoring organizations, is Principal of Blazzard Gradd and Hasenaver PC in Lauderdale by-the-Sea, FL.

received his AB degree in Economics from Stanford University and his J.D. degree from the University of California, Hastings College of Law and his Certified Life Underwriter (CLU) designation from the American College.

Our second panelist today is Kevin Marti. Kevin is an actuary and is vice president of reinsurance sales and marketing at BMA Reinsurance in Kansas City. Prior to joining BMA, Kevin was chief actuary at Westfield Life Insurance Company, where he spent nine years. Kevin also spent six years prior to joining Westfield Life as a consultant in the life insurance industry.

Our panelists bring both a legal and an actuarial background and will share their experience regarding legal, regulatory, and actuarial issues confronting small insurance companies in the area of product development and reinsurance.

Before I turn the session over to our panelist, I would like to draw a parallel between the role of the actuary in product development and the movie *Titanic*. Even with careful planning and diligent design work, whether it is a life insurance product or a cruise ship, there is no guarantee of success. You can develop the greatest products, but if you happen to be in the wrong place (or market) at the wrong time, there's no guarantee for success.

A second parallel can also be drawn from the movie the *Titanic*. Chris DesRochers, the scheduled moderator for this session, was kind enough to give his thoughts on the movie *Titanic*. He said, "The most meaningful conclusion that I personally can take away from the *Titanic* story is that the captain and the designer went down with the ship, but the White Star Line CEO left in a lifeboat." There are some risks that we product development actuaries take, and as a result, we must be willing to accept the consequences as well.

Our topics for today are going to be, "Problems and Opportunities of Small Companies in Product Development" as well as "Product Development Strategies." First, we are going to talk about product trends followed by a discussion on today's "hot products." With that said, I'm going to turn it over to Norse, who is one of the leading experts in the field of variable insurance products.

**Mr. Norse N. Blazzard:** When I was in the army, they used to define a *lecture* as the process by which the notes of the lecturer become the notes of the student without passing through the minds of either. That being the case, the object of this open forum is to not have a lecture. We want some dialogue because we are more interested in what you want to hear from us, for whatever it's worth, than we are in what we think about things. That's not to say that we don't have opinions on subjects because I can assure you we do. I'm known to have an opinion on any

subject, and if I don't know anything about it, I'm more likely to have an even stronger opinion.

I have lived in the variable product industry most of my life. The only thing that is more thoroughly regulated than a variable insurance product is nuclear waste. That presents both an opportunity and a challenge. If you look at the variable annuity business today for a small company, the challenges are very profound. I like to say that when you look at that variable marketplace, if you have distribution, nothing else matters. And, if you do not have distribution, nothing else matters because the name of the game is access to the marketplace, and the critical path in getting into the variable annuity business at the present time is the ability to access distribution. If you are so fortunate that you have within your organizations a captive distribution entity that can get products to the marketplace, then you are indeed very fortunate. That is true if that entity actually can get access to the marketplace with your particular product.

There are a couple of technical problems that come about as a result of the rules that are applicable to variable insurance products. Back in 1966, when I first started in this business, variable annuities were in their infancy. We were working on the regulatory structure for variable products. We, in our naivete, believed that if we came up with a state regulatory process that was at least as onerous as what would have been imposed by the federal government through the Securities and Exchange Commission (SEC), somehow the SEC would back off. What we ended up with was dual regulation, each one outdoing the other in an attempt to make our lives difficult. These problems become most pronounced in the marketplace.

We have two parallel tracks that we must walk when it comes to distribution of variable insurance products. One is the state insurance agent licensing process and the other is the process implemented by the federal government wherein the people who sell securities have to be registered representatives of a registered broker/dealer. In most instances, the broker/dealer is a member of the National Association of Securities Dealers (NASD). What many people do not realize is that when you hang your registration with a NASD member broker/dealer, you are permitted to sell only those products that the broker/dealer permits you to sell. The concept of brokering products within the securities industry, as we have practiced it for quite some time now in the life insurance industry, does not and cannot exist. If you are an agent of a life insurance company, and you have hung your NASD registration with a broker/dealer (whether it be affiliated with that life insurance company or not), the only variable insurance products that you will be permitted to sell are those that are permitted by your broker/dealer. If you sell a product outside those permitted by your broker/dealer, you have committed a very serious offense under the NASD rules known as "selling away." It is an offense that will not be

tolerated by the NASD in any way, shape, or form. I know, I have defended a number of them, and in most instances the penalties are Draconian.

To give you an example of how profound this problem is, I did a variable product registration for a fairly large company in the last couple of years that had well over 100,000 agents appointed with the company. When we took the variable products to market, we had fewer than 500 of those agents who were able to sell that company's products because of this registration problem under the NASD rules. So, the first consideration for a small company or even a large company looking to get into the variable product business—one of the hot products of the industry today — is how are you going to access distribution? Again, if you have a captive agency force that has the sophistication to sell the products, fine. If not, then you have a serious problem because you're going to have to access distribution elsewhere. When I first started in the business, if we had a group of this many people to discuss variable insurance products, they would have all had a pot full of tomatoes to throw at me because, in those days, everyone hated variable annuities. Now it goes something like, "Why don't we get off of this variable annuities kick, Norse, and sell real insurance?" Well, now that variable insurance products make up over half the total insurance premium in the country, they have a great deal more legitimacy. When I was a young insurance company executive trying to develop a variable annuity product line, I was told by my agency vice president that if he ever caught me in one of his agencies selling those variable annuities, he would have me tarred, feathered and ridden out of town on a rail. And, he meant it. So independent distribution was critical throughout the distribution of these products and it is just as critical today.

There are other critical-path items that you have to look at, and I'm going to let Kevin talk a little bit about that because I know that he has had experience in looking at some of the administrative elements.

**Mr. Kevin A. Marti:** At BMA, we just recently got into the variable market and addressed this problem head on. We at BMA wanted to have the best possible administration option that we could have getting into the variable market. I recently joined BMA in early 1998, but we chose to go outside and outsource the administration on that product. That's certainly not something that many companies are comfortable with. I think it's something that small or medium-sized companies are going to have to get comfortable with if they're going to offer some of these products. Many of our administrative systems aren't capable of handling the newer, more sophisticated products, so I encourage you to think along those lines. It's not necessarily a bad thing to have to go outside and out-source your administration on these products. It may be the only way you can price the products in a manner that you can make a fair profit as well. I do think that the

companies that are available out there to out-source the administration have brought the process forward to a point here they can handle the administration and do it at a price that's reasonable for most companies.

**Mr. Blazzard:** Let's assume that we have a solution to the administrative problem. Let's assume that we have a distribution capability. How does a small company go about developing the technical expertise to do a product? Can you do it with in-house resources? Do you have to go outside to lawyers or to consulting actuaries? The answer is, of course you do.

One of the problems that people have in this business is variable products are more thoroughly regulated than everything but nuclear waste. It therefore becomes difficult to build the in-house expertise, to have someone who can be dedicated exclusively to those technical elements that are peculiar to the variable product industry. You really can't afford to have somebody sitting there 12 months of the year when you really only need that particular expertise for three or four months of the year when you go through the technical elements of updating the products and keeping them current. It is probably cheaper and easier to out-source some of these elements than it is to try to develop the expertise internally.

When I talk about administration, folks say to me, "Norse, I don't understand why variable products are so difficult to administer." We in the insurance business are used to administering our policies and we've been doing it for a long period of time clear back to when we did it with quill pens and green eyeshades on tall stools like in a Charles Dickens novel. Why is it that variable products are so much more difficult?

It is important that you recognize that in the variable product business, the parameters are different than those that you deal with in the traditional insurance industry. In the insurance industry, if a premium comes in today for a traditional product, we put it in the general account of the company. The premium goes through the normal investment processes and when the policy is issued we can always look at a compound interest table and figure out what the value of the policy is. It's no big deal and it doesn't matter whether you do it this week, next week, next month or next year. Unless something happens to that product that gives rise to the need for us to address that product, it's a fairly simple proposition. It's a pure accounting function. That is not true in the variable product industry. By virtue of the fact that these are investment company securities subject to the rules imposed by the SEC, we live in a real-time environment. If money comes in today, we must do something to that money today because it's going to change tomorrow.

Those of you in the variable product business know that the most horrible words ever spoken in a company are "as of transactions." You have to go back and try to reconstitute what would have happened if you had done what you were supposed to do in the first place. I submit to you that is impossible, because the world has changed since then. Unfortunately, most of the administrative systems used in the insurance industry are not geared to that type of time constraint. Moreover, they tend to be tabular and driven in their architecture because that's the way we have done insurance from the beginning. In the variable insurance business, it is the separate account transactions that drive everything, so the architecture of our traditional systems is less likely to be effective in the variable product mode. Most variable insurance processing is done poorly and some of it is even worse. There are only a few companies coming to market today that have really looked at the variable insurance business as a different line of business and have designed the administrative capability from the ground up to make them work.

We don't want to make this exclusively a variable product mode. We want to talk about some of the other products, but I think that it's essential for the small company to recognize that there may be financial elements involved in variable products that do not readily come to mind. How many of you have a guess as to what the critical mass insofar as funds under management is that enables a variable product—either a variable annuity or a variable type of product—to break even? If I ask a question like that to a group of seven actuaries, I'll get 14 opinions. I'd like to get some feedback from the audience as to what you think the critical mass is for a typical company that you have to have as funds under management and a variable product mode in order to cover your development expenses and break even.

**From the Floor:** $100 million.

**From the Floor:** I'll second that.

**Mr. Blazzard:** When you say $100 million, do you mean that at $100 million, you will have recouped your development costs, and from that point forward you'll be making a profit on the block of business? Or do you mean that it is a going-forward profitable line of business?

**From the Floor:** I'd say going forward.

**Mr. Blazzard:** That's very interesting. I am somewhat more pessimistic. I think it is closer to $300 million and by pushing that within a reasonable period of time you've got to be looking at substantially more than that to cover the costs involved in doing it. Now why do I say that? If you go out in the marketplace and say—how do people sell variable annuities? Where do you go to sell your variable annuities?

The bulk of variable annuities today are sold by traditional stockbrokers, warehouses, regional broker/dealers and near warehouses. Some large companies have substantial volumes of sales through their captive agency force. I know that, for instance, Prudential sells more variable life insurance than anybody else does, but when you look at the variable annuity business, the bulk of the sales are still being done through the stock brokerage firm. Has anyone determined what it takes to get a stockbroker to sign a selling agreement to agree to sell your product? What if you went to Paine Webber and said, "Will you sign a selling agreement to sell my new variable annuity?" What do you have to do to get them to do it? Any ideas?

**From the Floor:** They come and inspect it, don't they?

**Mr. Blazzard:** They inspect you, but before they inspect you, there's something else that you have to do. You need to take out your pen and write them a check for a half a million dollars and that's just to get the hunting license. If you pay them the half a million dollars, you'll probably pass the inspection. If you actually want them to sell something, you're going to have to send your people out to sit down with their people, and you're going to have to give speeches at their conventions. They haven't paid for a convention in a long time. If you want to go out and give a presentation at their convention, you better write them a check for another $150,000 and they have five or six of these a year. The entry cost to get into the business is driven up, isn't it? We're not used to doing business that way. You therefore need to give some consideration to the cost elements and that's why I say the threshold to get into the business is probably higher than you think. It is because your compensation to get the product sold doesn't just consist of the commissions you pay. It's a lot more than that.

Are any of you selling variable life insurance? Are you selling modified endowment contracts or seven-pay contracts or both?

**From the Floor:** Both.

**Mr. Blazzard:** Is everybody selling both? Are you selling much? Do you think that's going to be the big market in the future? You hope so.

**From the Floor:** It depends on the stock market.

**Mr. Blazzard:** What are you guys doing on the reinsurance side? Are you seeing an increase in that volume of business?

**From the Floor:** No, not yet. We'd sure like to find some qualified customers to help us promote the sale of BMA's direct product though.

**Mr. Blazzard:** Is there a different reinsurance requirement for the reinsurance of variable life insurance than there is for traditional insurance products? There's just the plain old, same old, yearly renewable term (YRT) or something of that nature?

**From the Floor:** I think the actual reinsurance part of it is the same, but the difference is for us to be able to help a customer get into the market because of the barriers and the entry cost that you're talking about. They have to be able to produce fairly significant volumes of business to be able to justify the cost of getting them into the market.

**Mr. Blazzard:** Do you run into any problems? Suppose that you issue a variable life insurance policy that has, as the underlying investment, Tasmanian ragweed futures. The Tasmanian ragweed futures market is just going through the roof at 70% a year. At what point are you likely to punch through your retention limits and punch through the amount of reinsurance that you are willing to commit? Does that pose a problem that anyone has to deal with? I ask this because I'm spending a great deal of my time these days in private placement variable life insurance products with very high net worth individuals. Some guy comes in and says, "I want to buy $5 million worth of insurance on each of my children—one who is 22, 23, 24, and 25. We're going to put it into a fund that has a 70%-a-year investment return." In a very short time you will have blown through all the reinsurance you could get in the whole world, and then what do you do? You have to give back the money, don't you? You nearly reached your Section 7702 limits. It's a taxable transaction, and if the people who get the money are under the age of 59 (and it's a single premium product), you have to pay tax penalties as well. Even in the middle market, you have to bear in mind that the reinsurance elements involved in variable life insurance while the product may be "same-old, same-old" the application of the product can be dramatically different because it is likely to change depending upon the investment elements built into the product. Sometimes we lose sight of that fact, so that's another challenge.

I always say to my clients entering the variable life insurance business, we need to get the reinsurance arrangements put in place on day one and basically you ought to have the reinsurer help design the product. Similarly, it's wise if you can have your administration in place on day one. If you can build the product and the administrative capability for the product from the ground up so that you do not end up with square pegs in round holes, you are far more likely to have a product that holds together. As I said earlier, if you do not have distribution, nothing else matters. Even if you have distribution, you can lose it in a heartbeat because you stopped paying commissions on a timely basis to your distributors. They don't care how good your product is. Otherwise, you just shot yourself in the foot in the marketplace.

**Mr. John W. McKee III:** What if the product you're talking about is equity-indexed annuities? Is that $300 million number comparable?

**Mr. Blazzard:** I don't think anybody knows. The equity-indexed product is going to be as much a function of how efficient your investment capability is than it is anything else. Obviously, it is not subject to the same regulatory constraints as is a variable product, although the last shoe hasn't dropped on that one, as you are all aware. Are you all aware of where we stand on the regulatory elements in equity-indexed products. It's a fixed annuity with equity overtones. I think that we have some real potential market conduct issues if the product isn't properly sold. In many instances, the product has been developed so that we can have traditional insurance salesmen sell a security without having a security license. What's hotter than the stock markets? I'm going to sell you the Standard and Poor's (S&P) index, but I'm not really selling you the S&P index because I don't have to have a securities license because this isn't a security. I'm selling it as though it is a security. Guess what the law says? The law says if you sell it like a security, it is a security, regardless of what it actually is. Our friends at the SEC and NASD are trying to sort this all out and figure out what the rules should be. Many states have raised a lot of issues on it. I don't know the answer. If I were selling the product, I would be brutal in my compliance procedures to make sure that the proper story was told so that I did not run afoul. Do you know what happens if you sell an unregistered security? I think it's ten years in jail and $10,000.

**From the Floor:** Does the CEO or the actuary serve that time?

**Mr. Blazzard:** It is always the actuary. When I talk about broker/dealer activities, I always say we have to have the officially designated scapegoat. He or she is the person who gets to go to jail when something goes wrong. During most of my career in-house, when I worked in the home offices, my job was to be the scapegoat—that's why I don't do that anymore. I do not think that the threshold for an equity-indexed product is anywhere near as high. If nothing else, the entry cost isn't as good. You don't have to hire quite as many lawyers. You should, but a lot of people say you don't have to.

What does it cost to install a variable products system if you want to do it yourself? Should you develop one from scratch or buy one? They are pretty expensive. You can find a $1 million price tag and then you have the privilege of doing the modifications to get it to do what you want. In many instances it's like buying a car with no steering wheel, wheels, motor, or seats. I asked, "Couldn't you give me one that I just plug in the wall that works right off the bat?" They said, "We don't do it that way. We're not in the business of selling working systems when the business is on modifications to systems." I can appreciate that. So it can be a

problem. But there are basic functionalities that a system has to have if it is going to qualify as such. If it doesn't have the basic functionalities, then you better know that sooner rather than later. The system ought to be able to do data evaluation. I'll never forget one of the first variable life insurance products I ever worked on; they used an outside systems vendor and said, "We only process 28 days a month." I told them that they had to process every day the New York Stock Exchange is open for business. They said, "That's not reasonable." It doesn't have to be reasonable. It's just the rule.

**Mr. Marti:** Why don't we shift gears and talk a little bit about term insurance?

I come from a company that was very successful. Sometimes success is a double-edged sword—it can make your company more attractive for sale, but it's something that you have to have if you're going to continue to be operating on your own as a stand-alone company.

The competition today is in the term market. If any of you have gone to the different sessions, you realize that the product really has become a commodity. It's so easy to get something via direct mail or even through the Internet. I recently applied for some term insurance via an independent agent whose acquaintance I made at Westfield. After reading several financial publications and seeing websites like *www.instantquote.com*, I decided to go online to see what I could find. In about five minutes I had printouts on at least five top-ten companies for the different types of insurance I was applying for. I was off and running.

Companies like Zurich-Kemper are sending you something in the mail just about every day on term insurance. I'll be the first one to admit that reinsurance capacity is part of the problem. The competition for the first-dollar quota share arrangement with these large term writers is extremely competitive and it's certainly part of the problem and part of the reason why the pricing is at the levels that it is today. Throw in a few things like an unlevel playing field where some people have XXX and 147 compliance issues. Some reinsurers have issues that they have to address in that regard, and some don't. Some people find ways to dump things out into the ocean and make them go away. It's a very, very difficult time in the term insurance market. To add insult to injury, I still believe that there's an economic risk to those long-term rate guarantees. Let's put the reserve issues aside. I still think that we don't have any idea what the mortality is going to look like in the 20th and 25th year on a 30-year term. To add one more insult to injury, if you are a small company, the illustration regulations make you subject to the generally recognized expense tables as opposed to fully allocated tables. That makes it difficult for you to compete against some of the leading term writers. The market is really very, very interesting right now in the term insurance field and companies like BMA are

willing to help smaller companies do their best to compete in this market. Some people see the wisdom of doing that. Some people don't think it's their market. I would suggest to you that when you have competition for the savings dollar like we have today from mutual funds and banks and direct mail (for instance, a Roth IRA as opposed to a 30-year term or the 30-year rate guarantee), that's a pretty compelling argument against permanent life insurance. You can't just ignore the fact that the term market is there and hope that it's going to turn around. I would probably suggest that there is not a viable strategy for you going forward.

Norse said that some of the cost involved in getting into the variable market means trying to compete for that savings dollar. We have to figure out ways that smaller companies can get into this market and overcome the cost of entry, including technology, licensing and distribution related costs. How many of your companies use captive agents? Not quite half of the audience members raised their hands. That really becomes a very big issue when you're looking at variable distribution. The licensing issues with the broker/dealer are something that hopefully will be addressed at some point in the future, but at this point there's no answer. Companies like BMA that have developed variable products have invested both the time and expense. They must look for alternative distribution mechanisms to get the production they need to justify their entry cost into the market. For the time being, the variable market may be out of reach for the smaller life insurance companies.

Another large problem facing all of us is the rating agency challenges. Rating agencies do not like variable products. They don't like smaller companies. How many of you rate an A+ plus by AM Best? How big is your company?

**From the Floor:** It's huge.

**Mr. Marti:** It's huge and you can certainly understand from the smaller company's perspective that if you don't have size on your side, an A+ rating for AM Best is out of reach.

**Mr. Blazzard:** In fact, if you do not have a variable product capability, you won't get an A+ rating no matter who you are. The rule of thumb seemed to be, to get better than an A-, you'd better have a variable product capability. So if you're a small company, you're basically chasing your tail. You can't afford to do it, but you can't afford not to because you're going to be playing the ratings game. Have any of you had that experience?

**From the Floor**: I worked for a small company for the previous nine years. We watched our ratings flip as sort of a realignment. We were A+, and all of a sudden

we were A, and then we were A-. It does make it more difficult especially since we can't even touch the variable market anymore. We had a really hard time with our term insurance because of the cost of administering it. The development of that is very difficult as a small company. With this large company, the ratings really help them sell variable products. They will sell some of your products, even if it is less competitive than another company's product just because you have a higher rating.

**Mr. Blazzard:** I'm not sure why that is when you look at a separate kind of installation. You would think that the ratings issue would be less significant than it would be in traditional products, but I have found the same experience, particularly with alternative distribution systems like banks. If you don't have proper ratings, you're dead meat.

Are products becoming "commoditized"? Is the insurance industry developing only commodity products, like term insurance, in which you get the business if you're 1% below everybody else? If you're 1% above, you don't receive any business? Is there any future for relationship selling left in the marketplace for any kind of products? I'm not just talking about variable products and term—I'm talking about products across the board. How do you feel about that?

**Mr. Howard L. Rosen:** I think part of it depends on your target markets. If your target markets are relationship-driven and a lot of the upper income, independently wealthy individuals value advice and don't want to be in a transaction-based business, then there certainly is. If you sell a commodity that works, and if you sell based on relationship, having a virtual company does not work. It's not the way that the culture of the company works; it's not the way that the sales force works, and it's not going to work with your clients. That's because when they call up, they want to talk to the fostering company of the agent with whom they're doing business. I think that the answer to that question really depends upon the culture of the company and the target markets.

**Mr. Blazzard:** Is the commoditization taking place at the consumer level or is it taking place at the producer level? If it's taking place at the producer level, then pricing becomes critical. How do you establish relationships with the producers unless you're one of the fortunate few who have or think they have a captive agency system?

**Mr. Rosen:** One of the things that we do is we are not going for market share in any one product; we're going for client share, which means that when our field force approaches a client or a prospective client, we're not interested in selling a term product per se or a disability product or a 401(k) plan if it's a small company. We're interested in assessing the client's needs and trying to meet those needs. We

do that with a very broad product portfolio. I'm not sure I've answered your question but again I get back to the way the product is sold and the culture of the company.

**Mr. Marti:** When I checked the Internet, for term rates, I was very surprised to find companies that would be among the leading term insurance writers in the country. The range of prices in those top ten companies was a lot wider than I would have ever guessed. I was quoted preferred best for $1 million of 20-year term for a 41-year-old male. I would have never expected to get it, but somehow I did.

If you get a distribution force in the ball game that has any loyalty at all, it will typically sell your product. I'm not trying to discourage you from getting into the term market. I'm trying to encourage you to get into the market. It may require you to think differently than you thought in the past about how you get there. If you're developing a product, and you're significantly more than 20% out of the market or you're going into new underwriting classes or something that you're just not comfortable with, that's the time to pull in an outside resource. A reinsurer or an outside actuarial consultant can provide the help you need to do it right and have a better chance of succeeding.

**Mr. Blazzard:** Gentlemen, let me ask you a question. Is there a place in that environment for niche marketing? I always look at it in the variable product area. If you look at the variable annuity, for instance, you'd see that the top 15 companies in the industry have something like 80% of market share. A small company trying to enter the business to go head to head might be an exercise in futility. It seems to me that there are a lot of niches for not only variable products but across the board. They have been, for one reason or another, ignored by the industry for a long time. I'd be interested to know the reinsured's point of view about where you find them and what kind of products you would look for.

**Mr. Marti:** We're always looking for them. We haven't found too many markets that aren't compatible from a reinsurance standpoint. Some products are for critical illness and long-term care. I don't know whether that's something that's of interest to smaller companies or not. Many of them don't write disability, so it's hard to imagine them branching out into a long-term care or critical illness product. Pre-need is a market that several small insurers are in, and I think they do quite well. It's a very specialized market. I think you need some expertise to be able to succeed there as well. Worksite marketing is another one. We were certainly doing a fair amount of that at Westfield. Nearly 15% of our business was coming from worksite marketing. Once again, you need a niche to be able to get into the appropriate kind of groups so you can sell worksite marketing cases.

**Mr. Blazzard:** How many of you are in the long-term care business? How many of you are in the disability income business? How many of you are making money in the disability income business?

**From the Floor:** I hope we are.

**Mr. Blazzard:** I ask that because I spent the last seven years helping the Massachusetts Insurance Company try to clean up Monarch Life, and I don't think wild horses would get me in the disability insurance business because the claims experience is too subjective. If somebody dies you can pretty well tell whether he died or not. However, if you're in the disability insurance business and someone can find a witch doctor out in darkest Africa to certify someone is disabled, you better pay him or that person is going to file punitive damages against you. This market tends to scare me a little bit.

I do like the long-term care market. It's one of those things that struck me like reverse mortgage annuities. It's a wonderful idea, but the dogs don't want to eat the dog food. Anybody who can afford it doesn't need it, and anybody who needs it can't afford it. I'd sure be interested if somebody could share some experience. It's one of those things I see a lot of discussion about, but I sure haven't seen the sales volume to back it up. If somebody has the secret to that, I'd like to know what it is.

**Mr. Philip D. Morland:** I had some experience with long-term care at my last company. I did a morbidity study to see what the rate of claims were. I was surprised that after the first couple of years of high claims it dropped back down to the expected level. I believe what we experienced was antiselection right off the bat where people who needed the long-term care got it. Perhaps they shouldn't have, but there was an aggressive market at the time and we were selling. I think there's always a danger of antiselection when you're talking about something like this because the people who need it are the people who are probably going to buy it. That was my experience.

**Mr. Marti:** Perhaps this is a better option for companies our size. We've been contemplating the idea of developing a long-term-care rider and/or an integrated product that involves a universal life and/or whole life chassis with a long-term care benefit built into the product. The policy would pay out some percentage of the death benefit for every month the insured was confined in the long-term-care facility. For whatever reason, I don't know if we designed it the wrong way or if the pricing just wasn't right, but we didn't sell much. I've been hearing more about this type of product. There seems to be a market now for disability income riders attached to whole life and universal life products. Does anybody have any thoughts on this? Is it a product that may have some appeal to a younger person who might

have a hard time seeing himself in a nursing home? I can't see myself buying a long-term-care policy and paying level premiums for 20 or 30 years and then possibly dying before I ever go into the nursing home. I can, however, see myself buying a universal life policy with a long-term-care feature built into the product. It might provide a death benefit if I die before I go into the nursing home or provide for the surrender of part of the cash value at retirement so the premium can be used for something other than a long-term-care facility. I'd be interested to know whether you think that has any appeal or not.

**Ms. Patricia A. Peebles:** I did some research. The claims payout for a rider to a policy is as difficult as a stand-alone. Because of the Kennedy-Kassebaum bill, it is not worded correctly, so the cost of insurance that's deducted to pay for your long-term-care rider is possible income to the owner, which causes a real headache when you're trying to administer the rider. In a lot of states, you are required to have a qualified plan. You must also sell a nonqualified plan that affects your guideline premium calculations which is also a problem. It is more attractive in the younger age market. I don't know why it doesn't sell, but I think it's because the agents who sell life insurance don't completely understand long-term care.

**Mr. Blazzard:** This is something that I think we must always bear in mind. Back in the 1970s, when we did the first big selling of variable annuities, it started with the grandfather of all business today. It was a joint venture between Nationwide and MFS. People used to beat up on me regularly by saying, "Norse, I don't know why you keep talking about those blankety-blank variable annuities; everybody knows you can't sell them." I would say, "How do we know? Nobody has ever tried." The same thing is true of a lot of these other products that we talk about. Conventional wisdom says they won't sell. If we haven't done the job of teaching people the story we want them to tell, maybe we're missing the boat. That may be one of the niches that we should be looking at in these marketplaces. I know we are beginning to see more and more people on our side of the house looking for additional bells and whistles to hang on their variable products to differentiate their variable product.

As I sometimes say, I think I practice spreadsheet law when the guy comes in and says, "I want the same as the last 14 products you did, but I want two more checkmarks after my name." You did it for the last guy, so we're going to roll up the death benefit every 20 minutes instead of every half an hour. People are looking at disability income (DI). What are the tax ramifications of putting a DI policy on a traditional life product of some sort? Does that cause you any problems? Can you do it with an annuity? What is the coverage? There are losses that you have "DAC-ed" at the highest rate. If you combine a product that has a low DAC with one that has a high DAC, you run the risk that the high DAC is going to

cause you to defer the acquisition cost of the whole thing. This will certainly affect your profit assumptions.

I've always been a little bit reluctant to get too wild on some of these kinds of things because nobody understands the tax ramifications—most assuredly not the IRS. One thing I do know is that they work on the assumption that a Smith Wesson beats four aces.

Have any of you ever had the opportunity of negotiating with the IRS? It's like negotiating with the hangman. You get to negotiate the height of the platform and the length and the thickness of the rope and the time of the day. The ultimate issue, unfortunately, isn't something that you can discuss.

**Mr. Marti:** Would anybody be willing to share how their company is using the Internet to work with their agents and/or their policyholders at this point? I just came from one of the Internet sessions. I thought it was very interesting. One of the questions they asked was, do you know who owns the website *www.insurance.com*? It is Fidelity. That's discouraging, folks. Fidelity has a website. I would have thought some good, aggressive small company would have snapped that up.

**Mr. Blazzard:** When I was in San Francisco at the variable life meeting, we had a seminar on selling variable life through the Internet, and we had a panel of three CEOs of major companies in the business. All three said they had websites. All three said they had thousands of hits on the websites, but none of whom had any fulfillment capability of doing anything once they got one. I submit that may very well be a broader case than any of us recognize.

I'm reminded of when ERISA went into playback in 1974. I designed a program to sell IRAs through a bank in Massachusetts, and it was beautiful. All the sales material was integrated and I was up in the head office of the bank when they did the launch and we got a phone call from one of the branches. The manager said, "I'm calling from the pay phone out in the lobby. I have one of those guys who came in on one of those IRAs. I gave him all the stuff, and he still won't go away. Now what do I do?" Sometimes I think that's what we're doing with the Internet. Everybody talks about it, but no one looks at really fulfilling what it is they want it to do. I applied for an insurance policy, and I'm supposed to know this business. My eyes are still crossed trying to figure out what I put on what form and where. I think if we're going to do it, we have to make it a lot more user friendly: name, rank, serial number and how much money do you want to send. I tried to buy a variable life insurance policy for my newborn granddaughter. I said I want to put in $5,000 a year until I die. They said, "How much insurance do you want?" I said, "I'm not

buying it for how much insurance I want. I want to put in...." They said, "We can't do it that way. You have to tell us how much you want, and then we can tell you whether we can do it for $5,000." They are putting the cart before the horse on this kind of stuff. I think that all of us on the product development side of the business need to sit down and figure it out. We need to find a way to make our product more user friendly, both from the design standpoint and from the delivery standpoint.

**Mr. Marti:** I was just wondering if people were looking at using the Internet for the service aspects of their business as well as providing customer service forms, illustration software, and even providing access to policyholder values. It seems to me that many of the people that we compete with today offer that kind of access. I'm referring to the mutual funds and the banks and so forth. You can typically call a number and get on the Internet and do something 24 hours a day with these companies. I'm just concerned that we don't, as an industry, have more of a 24-hour, around-the-clock service capability.

**Mr. Blazzard:** It isn't just a matter of the service capability; it's also a matter of the expense factor. I don't know how many of you have ever sold your variable products through the pizza box. You might go to A. G. Edwards or Paine Webber and buy variable annuities. They will deliver you a pizza box full of stuff. If you spent the rest of your career reading that stuff, you still wouldn't understand it. I know I write it and I don't understand it. The pizza box contains everything you wanted to know about your variable annuity and your variable life insurance. You are going to get a headache and say, "Well, I'll get back to you someday." Wouldn't it be nice if you could deliver electronically with hyperlinks back and forth so the customer could hone in on what he wanted and you could fill out the forms right on the spot: name, rank, serial number, and how much money he wants to send in. This is a technology that is there; we're just not using it

**Mr. Mark D. Biglow:** We had a client come in looking to do some Internet work and they wanted to put out illustrations on their annuities. The more time we spent talking with them, the clearer it became that they had no idea what it was they wanted, but they had to have it by the middle of November, and wanted to know if we could do it. We said, "Do you want them to access their own values?" They said, "No, it's going to be for the agents." We asked, "Do they have to access any values?" They answered, "No, it's just new business. It would be good if they could access the values." We said, "How are they going to get...." They said, "We don't know." They had no infrastructure to deal with it. They did not have anyone designing any of the connectivity, but they had to have something out there by the middle of the month, and I think that may be an indication of where some people

are right now, and why they're not successful. They have to be there, but they don't know what it is they need to do to be there.

**Mr. Blazzard:** I think that's a valid point. Let's talk a little bit about investments. Does anybody think that fixed annuity products and fixed products are going to come back with the economic conditions the way they are today? Remember that in the 1980s we had a weird situation where money market funds and certificates of deposit had double-digit yields. Baldwin United and other companies that were selling annuities were guaranteeing a 16% yield forever. Are we in a position now in which we could find ourselves in a bear market with interest rates so low that we didn't have anything to sell? Is that a possibility?

If you look at the yield on fixed annuities, by the time you, the consumer, eventually pay the taxes and go through inflation, you would lose money on the deal. If the interest yield stays the same way it is, and the stock market goes in the tank, we'll be hurt won't we? What are we going to have left to sell? We'd better start selling mortality. Wouldn't the right to sell a capital needs analysis be a unique thing? That's what you were talking about. How much do you need if you live? How much do you need if you die? How much do you need if you retire? Wouldn't that be a unique thing?

We've started pushing retirement annuities—annuities that actually annuitize. I started in the 1960s selling retirements. Isn't that an amazing thing? I happen to believe very strongly in it. I always say that my will reads: "Being of sound mind I spent it all."

The only way I know that my money and I can end at the same time is with the life contingency annuity. I look at some of these IRAs and the other things that people sell these days. I always have in my mind's eye the little old lady who comes into the bank who rolled over her 401(k) when she retired into an IRA. Banks can't offer life contingency annuities, can they? They can do it for life expectancy. This little old lady comes in and says, "I didn't get my pension check this month." They look up the records and say, "That's because you're dead. It says so right here—the IRS Annuity Tables say you're dead. You died last week." She says, "But I didn't." "Well, that's not our problem. We guaranteed you for life expectancy and if you didn't have the common decency to die when the tables said you were supposed to die, that's not our problem, is it?" The lady says, "But when you sold me this thing you told me it would protect me for life so that I could retire and have investment security. You said I wouldn't have to worry about all these things. Now that I'm 83 years old and I need the money the most, you tell me it isn't there anymore?" I predict that the little old lady is going to go and find one of my brethren in the legal

business and find 12 truck drivers to sit on a jury and the bank is going to pay for it anyway.

If I were a plan sponsor, or if I distributed IRAs through mutual funds or banks or any other element, I would not allow anyone to take a life expectancy distribution unless I had offered them a life contingency. If I did so it is like asking for my brethren to get very rich in the future because of those people who do not have the common decency to die when the table said they were supposed to. Is that a niche? It might be one.

**Mr. Paul J. Sulek:** I haven't been with a company for some time that has tried to sell immediate annuities with any degree of aggressiveness. I've also never been with one that has been successful at it. It always seemed to me that the amount of return that we, as actuaries, were willing to give the purchaser of an immediate annuity wasn't a whole lot better than what that person could do in an interest-only type of extraction, especially if they wanted ten-year certain. In view of that, the only real solution might be a variable immediate annuity. Are you working in that area to any extent, and do you see that as a successful option?

**Mr. Blazzard:** Yes, big time. There are several companies that come to market with a variable immediate—if you look at the deferred variable annuity marketplace, fewer than 5% of all issuers offer a variable payout option. Isn't that amazing? With most variable annuities, if you buy one and want to annuitize, you have to take a fixed option with it. Why? It is because they can't administer it. It is somewhat difficult to administer, but it's not impossible to administer. It's just that we haven't gotten around to it, but they are beginning to.

There are several companies, including your friends at Fidelity, that are actively engaged in the immediate annuity business. It is important for us to recognize that from the legal standpoint. Under the Internal Revenue Code, there is a difference between the deferred annuity that annuitizes and an immediate annuity. They're two different animals from the tax standpoint. It's important that everyone understands that. I can do things with an immediate annuity (defined as one that annuitizes within 12 months of the date of issue) that I cannot do with the deferred annuity–once a deferred annuity, always a deferred annuity. It is a deferred annuity that is annuitized, but it is still under the deferred annuity rules. I can't back myself into superior tax treatment by annuitizing, so there are two distinct markets and the mere fact that I do a 1035 exchange of a deferred annuity for an immediate annuity issued by someone else doesn't change the status of the product. It would be nice if it did, but the IRS isn't that stupid. I have several clients, including you folks, that are coming up with an immediate annuity for the qualified plan marketplace. In the qualified plan marketplace, you are seeing more and more plan sponsors who are

worried about what I just said. They have this 404(c) pre-retirement counseling obligation that they're required to do before somebody retires. They are worried that they teach them all about asset allocations and dollar-cost averaging and alphas and betas and all those other wonderful investment things that we all understand, but they don't talk about outliving the funds available for retirement. Are they liable to their employees if the employees outlive the funds available? From my standpoint, I would not allow my people to retire without at least explaining to them and making available to them a life contingency annuity. It is the only vehicle in which you can be sure that you and your money will end at the same time.

Consider the earlier question about the fixed annuity versus the variable product. The only experience we have in the variable annuity area goes back to the College Retirement Equity Fund, which was the first variable annuity. People retired on them drawing $10 a month. Two of the eight people who bought it the first year are still alive. Isn't that amazing? Do you know what they're getting a month today for the $10 all those years ago? About $1,100. That is nearly twice the rate of inflation.

If you will recall, the variable annuity was designed as a retirement tool to hedge against inflation as well as to protect against living too long. We talk about long-term care. We talk about premature death, but we forget that an annuity is the finest way to protect ourselves against outliving the funds available for retirement. I think that history will record that probably the best bargain that anybody ever bought were the annuities that have the annuity tables that we've been using the last few years. One actuary said to me during a conference in New York in the fall of 1997, "You guys better take long, hard looks at your annuity tables. Make sure you're not giving away the store. It wouldn't take much improvement in mortality." I don't know, I'm not an actuary. Let's talk about product development strategies. I'm going to get on my soapbox again.

When you're dealing with nontraditional products, products that are hot in the marketplace, products which may have a shelf life shorter than it takes you to develop the product, what does that indicate to you? You'd better improve on your product development timing, hadn't you? So the question becomes, how do you do this? I have seen the costs, for instance, in developing variable insurance products with a range that is beyond belief. When I was chairman of the National Association of Variable Annuities, I did a little study of such things as the average contract administrative cost annually. Its range ran from $20 on the low side to $140 on the high side. I submit it is a range that is meaningless in their world. I have seen product development costs range from as low as $75,000 to as high as $100,000, which is likewise a range that is beyond belief. Why is there such a difference? It comes down pure and simple to management control of the process.

People who are in charge of developing these high-tech products have to be freed from the other things they do so they can concentrate on this. They have to be empowered to make decisions and many of the decisions are not value judgments. What's better—chocolate ice cream or vanilla ice cream? It doesn't matter, but make the decision before it melts.

You need to cut a clean edge. Any decision is a ragged edge. You have to have someone in charge of it, I have seen wonderful product developments that have had actuaries in charge; I've seen ones that have had lawyers in charge; I've seen ones that have had marketing people in charge. The main thing is that the task force empowered to do this must be willing to do it full time. It must be willing to make decisions and to implement what needs to be done. If the task force does not, then you will see your costs skyrocket. Lawyers, consulting actuaries, and accountants are not cheap. They love to rewrite stuff over and over and over again at high hourly rates. The way that you do that is you make sure that you have your ideas in line first.

Over the years, we have found that in the variable product area, it is an absolute must that everyone first get together and come up with a common idea as to what the product design should look like. This should happen before anyone puts a word on paper for either a policy form or a prospectus. You would be amazed how often we get called in to consult on products where we've seen a prospectus. The policy forms bear no resemblance to one another. In the variable product mode, do you know what the prospectus is supposed to do? It's supposed to disclose what's in the policy. If the guy who wrote the prospectus never read the policy, that's a little hard to do. That happens frequently.

First of all, come up with a product memorandum that is signed off on by everyone—the lawyers, the actuaries, the administrative people, the marketing people, and the underwriters so that everyone has agreed to what the basic premises are involved in that product. Then write a policy form. Get everyone to sign off on that. If you've gotten everyone to sign off on the product memo and the policy form, the prospectus writes itself. You could hire a chimpanzee to do that. The most important thing to have is a management team that is working as a team to understand what it is that they do. You don't want to be in a position to where you don't have time to do it right, and you have to do it over. Every time you do it over, it's going to cost you a ton of money and the outside technicians will just love it if you let them rewrite the thing over and over again.

That's something I feel very strongly about because I inevitably get the blame when it costs more than it should because people don't use the time of the outside consultants effectively.

**From the Floor:** This is a question about current in-force products that we have to deal with somewhat in a product development modality. I'm thinking particularly of compliance with respect to universal life policies that are out there and a lot of big companies have paid a lot of money as a result of that. I'm not sure that small companies have paid a lot of money yet. Are there things that small companies are doing proactively? Do small companies feel threatened by the same types of things that are bothering the big companies?

**Mr. Blazzard:** I think that market conduct is a specter that will be around small and large companies. Obviously, if I am a politician or litigator trying to make a name for myself, I'm going to go and pick the golden nuggets off the top of the ground before I start digging holes to find the ones beneath the ground. Your turn will come. Market conduct is here to stay and it is something that needs to be addressed. You should not allow it to hamstring your marketing efforts, but on the other hand you don't want to play into the hands of the people who would destroy you by doing stupid things. Many things that we do, we do inadvertently. When we had the vanishing premium debacle years ago, no one was trying to cheat the public. It was magic and everybody believed that interest rates were going to stay the way they were. We really believed that we had told people that this was not guaranteed. In fact, it could self-destruct. I don't know if any of you read an article we wrote on the subject in the *National Underwriter* a while back, but the problem is one of 20/20 hindsight. Lawyers who design compliance programs have a tendency to fall into the trap that all lawyers do. Lawyers are trained to see the things that went wrong. We don't study the things that went well. We only study the things that went wrong—like if somebody did it and got sued. When we get out of law school and we go into the corporate world, we are interested in finding and preventing the things that went wrong. That is certainly a valid approach. It is also important to design a positive compliance program. Have the lawyers sit and look at the land mines that you are planting out there that you can step on yourselves. One of the areas that I am very concerned about is illustrations, both in the variable product and in the nonvariable product mode. They lend themselves very strongly to 20/20 hindsight, don't they? When we issue an illustration, what is the one thing we know? It's never going to be that, is it? I'm an old litigator. I always find myself saying things like (pretend Kevin is on the stand), "Sir, isn't it true that at the time you issued this illustration to my client that you knew this could never come to pass?"

**Mr. Marti:** "That's correct."

**Mr. Blazzard:** "And you issued it anyway, didn't you?"

**Mr. Marti:** "Yes, sure did."

**Mr. Blazzard:** "So basically you misled my...."

**Mr. Marti:** "Marketing people told me to do it."

**Mr. Blazzard:** I always say to clients, "Assume that old Norse has got you on the witness stand and he's hammering away at you. What have you done to make my job easier?" I don't litigate any more, but how would you like to have to sit there and answer those kinds of questions? So do we have to use illustrations? We don't have much choice, do we? Does that mean we want to have three pages of mouse type saying, "This isn't really true," for every page we have of illustrations? I don't know what the answer to it is. I know that it leaves me feeling very uneasy. People say you have to have illustrations for people to understand the product. Since the marketing people tell me that, I know it's true. However, it doesn't change the fact that I look at the potential 20 years from now of me having to sit in court and say, as we did about the vanishing premium, "But everybody thought it was going to be the same. We thought we were going to earn 12%." You could be torn apart for doing it on that basis. This is the problem that's true for both small companies and large companies. It's just a question of when will your turn come.

**Mr. Blazzard:** It's sort of like getting the "Good Neighbor Sam" sticker and putting it on your car. While it certainly is a step in the right direction, and it is intended to be an exercise in heat transference, it doesn't change the fact that you cannot institutionalize good business practices. Good business practices mean you sit down in advance and look at what it is you are doing. If it is a bad business practice, don't do it.