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THE LIFE INSURANCE POLICY OF 1975 —EQUITY BASED?

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Editor's Note: The following article is adapted from a speech originally delivered to the National Association of Insurance Commissioners.

If you will think back to the first half of the 1960s you will recall that the following positions were very widely, if not universally, held in the life insurance industry. "The sale of mutual funds by life insurance agents is not to be countenanced." "The variable annuity is a product that is contrary to foundations and purposes of life insurance. It is unsound and improper for an insurance company to hold major interests in other enterprises," and, similarly, "the takeover of a life insurance company by an outside interest is almost a fate worse than death."

Today, just a few years later, these statements sound so uncomfortable and so out of place that they seem almost to belong in a different century. The list of companies grows that are actively involved in the securities market at the retail level, or marketing or developing variable annuities, or involved in a holding company structure. Even mutual companies are strongly moving in this direction.

A whole new jargon has come into our business. Many of these are not new words but they are to us. In addition to upstream and downstream, there is conglomerate and congeneric. I heard a new word in this area a few months ago when the comment was made about a life insurance company diversification program that it was consanguinic. The context seemed to indicate that this implied that the various components of the corporate structure were in related fields and complemented each other, but it could also perhaps have simply meant that there was little jealousy or friction between the components—thus a sanguine atmosphere. The word sanguine in this context means "warm, ardent, disposed to be hopeful, anticipating the best." I looked the word up in the dictionary and would have been all right except that I noticed that the word immediately above sanguine is sanguinary, and the first dictionary meaning for this word is "attended with or concerning much bloodshed" and the second definition is even more interesting: "bloodthirsty; eager to shed blood." After this, I decided that there must be a great deal more to the word consanguinic than I had at first thought.

A number of reasons have been prominently displayed in the news media for these changes that are taking place in our industry. Probably, most commonly, consumer demand is referred to. Inflation is also commonly mentioned. It is true that we have been and are in a period of much higher annual rates of inflation than have been experienced for a long, long time in this country. Fixed dollar savings and people on fixed incomes are among the more severly affected by such continuing inflation.

It is often stated that our rapid entry into these new areas is in response to powerful consumer demand for inflation-hedged savings media. However, we miss a very important force if we content ourselves with this inflation hedge analysis. A more important feeling in the marketplace is the desire to be a part of the growing economy. Insofar as there is a consumer demand, it is more in the nature of a positive force looking for participation in growth, or, as we like to put it, "a piece of the action" rather than the negative force of fear of inflation.

Index Contracts

Although this idea leads me to the conclusion that variable life insurance will be a much more important factor in the market than will index type contracts, I want to describe index contracts in very general terms before getting into the subject of variable life insurance. Most typically today, an index type contract will provide that the face amount of insurance will follow some index, generally the consumer price index prepared by the federal government. These contracts usually have some limitations on the amount of variation, either in the form of a maximum annual amount of increase such as 3% or a maximum total amount over the life of the contract such as twice the original face amount. Also, almost invariably, these contracts provide that in no event will the face amount be less than the initial face amount.

This benefit can be added as a rider to a base policy, or may be a part of a term insurance rider or in what is perhaps one of the most sophisticated approaches built in as a part of an ordinary life contract. There are many other possible approaches to index type contracts. One that was issued for quite a number of years tied both the face amount and cash values to the Dow Jones industrial average. While there may be exceptions, these contracts generally are not considered to be subject to SEC jurisdiction, principally because no direct investment risk is carried by the policy owner. It also has seemed to be generally true that relatively little change has been necessary in the insurance laws to accommodate these contracts. These regulatory aspects have enabled considerably more rapid development of index type contracts than is going to be the case with variable contracts.

Now as to variable life insurance, I have in mind a rather wide range of possible contracts here too, but my definition of a variable life insurance contract would include all of those contracts that provide a significant death benefit and under which the assets are accounted for separately so that the investment results may be assigned directly to the policyholders. There has been considerable activity with this kind of contract in Europe and in Canada, especially since World War II. However, the types of contracts that have been developed there have generally been considered to be incompatible with the concepts of regulation in the United States.

The presentation of a paper on variable life insurance at the 1969 annual meeting of the Society was followed by many discussions. It is not possible for me to go into any technical detail about the kinds of variable life insurance that these discussions contemplate. In broad, general terms, some of the features that seem to characterize most of the approaches would be life insurance with fixed annual premiums and with both face amount of insurance and cash values responding directly to some measure of the investment experience in a separate account. It seems likely that a minimum guarantee attached to the death benefit is both technically feasible and likely to be very popular. Similarly, it also appears that it may be technically feasible to include a minimum cash value guarantee. How popular this may

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be will depend on how much extra premium will be necessary to pay for it.

The NAIC at its meeting in December 1969 adopted a model variable contract law and a model variable contract regulation. These documents are intended to accommodate the development of a broad range of variable life insurance approaches in a manner that is reasonably consistent with the existing regulatory concepts as to nonforfeiture, valuation and policy provisions.

At the federal level, variable life insurance poses what may turn out to be a far more difficult regulatory problem. The Securities Acts of 1933, 1934 and 1940 simply did not contemplate this kind of contract. These laws were designed to deal with pure investment contracts. As you are well aware, the variable annuity has posed some very difficult problems in adjusting to SEC regulation. Because these laws did not contemplate the kind of arrangement that variable life insurance is, the complete imposition of the securities laws probably would serve to totally prohibit the sound development of variable life insurance.

Serious study is being given, cooperatively with the SEC, to the possibility and relative desirability of exemption for variable life insurance from the federal securities laws and, alternatively, the development of new legislation. The problems of dual regulation and the powerful and sound rationale for treatment of variable life insurance as an insurance product have some important implications at the state level. It is very important in this context that the various state Blue Sky laws not be imposed on variable life insurance.

As has already been indicated in my earlier remarks, there is a wide variety of possible approaches. Index contracts may have the face amount tied to an index such as the Consumer Price Index. Cash values and even premiums may also be tied to an index. The benefits and premiums rather than being tied to an index can simply increase a given percentage each year.

The variable idea is capable of an even greater variety of solutions with one or more of face amount, cash values and premiums reflecting in some way the investment results of a separate account. Minimum guarantees may be attached to some or all of the benefits.

It is true that the investment results of a separate account may not correlate with a cost of living index and thus, at least in the short run, a variable insurance policy may not serve as a hedge against inflation. However, it is my opinion that variable insurance is going to prove to be more popular than index contracts. It is also my opinion that increasing premiums whether they be indexed or variable will not be successful in the marketplace. I have heard the opinion stated that while a guarantee of the death benefit is quite feasible, a minimum guarantee of cash values under a variable policy will be too risky.

My purpose in reciting these opinions is to lead to the statement that the regulatory atmosphere should not reflect personal opinion, either mine or yours. The whole range of emerging product ideas should be accorded the opportunity for marketplace testing. I'm sure it is possible to design an index or variable contract that would be fraudulent or contrary to public policy but none of the ideas that have been discussed so far has made me uncomfortable in this context.

Question of Risks

It has been suggested also that more stringent capital and surplus requirements should be imposed for a company writing index or variable contracts. There is absolutely no theoretical, legal or practical reason for doing so. It is simply an effective device for preventing the small company from entering this market. Inherently, by the nature of the risks involved, it can be said that the company will bear a smaller risk than with fixed dollar contracts. Certain index type contracts and certain cash value guarantees may develop risks that are of a size as to be unwise for a small company to keep, but there is no reason why reinsurance arrangements can't be worked out just as they have been with large amounts of insurance under conventional life insurance.

The NAIC model bill and regulation are a very excellent beginning and while the necessity to assimilate a whole new field of relatively complex and technical knowledge is going to make our lives a bit more complicated in the immediate future, I am confident that broad, general principles and patterns will emerge relatively quickly.

Comparing the sort of problems that variable life insurance may pose to the problems that we have greater familiarity with in dealing with traditional fixed dollar insurance, seems to indicate that variable life insurance will adapt rather smoothly and easily to our existing concepts of valuation and nonforfeitures. Most of the policy provisions make the transition very easily. The grace period provision probably cannot require that the premium be credited as of the due date but should permit crediting the premium to the separate account as of the date received.

Reinstatement

Another example is reinstatement. The mere payment of back premiums and fixed interest can produce both serious investment antiselection problems and intolerable financial burdens unless it is modified in some way, either requiring reinstatement on the payment of the increase in cash value (plus a small loading) if that is greater than the premiums plus interest or perhaps permitting reinstatement on the basis of back premiums plus interest with an appropriate adjustment in the variable face amount.

The stickiest policy provision problem seems to be with regard to policy loans. There are a number of ways being explored for providing some form of policy loan but it does seem quite apparent that a fixed interest loan against a separate account is just not feasible. The model bill and regulation have attempted to cope with these kinds of problems.

And now in conclusion, if I may venture an opinion as to the future, I need to make a few assumptions. Assuming that the various states move reasonably forth-rightly to incorporate the model variable contracts law and regulation, suitably modified as necessary to fit each state, and further assuming that the SEC is able to grant exemption from the securities laws for variable life insurance, then my guess is that within five years after it becomes possible to market this new insurance concept, it will be producing at least as much new business and premium volume as our traditional products will be producing. □