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Market Cont'd.

going wrong and has some idea of how it can be fixed. The actuarial department also has dedicated specific resources to working on products and improvements on products for this market.

The last area to be addressed in this market is the need for the agent to do the appropriate servicing at his end. If there is anything we all do know, it is that servicing of the products in these plans and the servicing of the plans themselves are not inexpensive things for the agent to do. We certainly don't know where ultimately the funds will come from to pay for this servicing. Some of it will come as it traditionally does from commissions; some may come from fees. But we are sure that the agent who is able to do this work as efficiently as possible will have a large advantage. Part of this efficiency comes through enhanced home office policy servicing systems; but much of it must come from the agent himself, or his designated representative. Ultimately, that servicing entity must have a system within his own four walls to keep track of all of the plan data and the policy data. That is the last piece to be put into place.

Northwestern Mutual is excited about this market. It has great potential; and it's a lot of fun to sort out the pieces, put them in place, and hear the satisfaction from the agents as they increase their sales.

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TSA Papers Accepted

Four more papers have been recently accepted for publication in the *Transactions*, Volume 40. The papers are:

James D. Broffitt, "Increasing and Increasing Convex Bayesian Graduation"

Mark D. J. Evans, "Amortizing Acquisition Expenses in Proportion to Premium Revenues"

Thomas N. Herzog, "Analyzing Recent Experience on FHA Investor Loans"

Harry H. Panjer, "AIDS: Survival Analysis of Persons Testing HIV+"

Variable Products— Today's Design Trends

by Timothy C. Pfeifer

New variable life and annuity products have been growing in prominence in the portfolios of many life insurers. Today's products have evolved from the original forms issued in the late 1970s and early 1980s. SEC and state insurance department regulation, as well as increasing consumer sophistication and competition, have shaped the design of these products. We'll examine some of the recent trends in the design features of variable products. Nearly all newly-developed variable life contracts are either flexible premium variable universal life (VUL) or single premium variable life (SPVLI), as opposed to annual fixed premium variable life (VL). Past SEC regulations effectively prohibited premium flexibility on variable life contracts paying typical whole life commissions. In 1983, temporary rule 6e-3(T) enabled VUL designs. Since then, fixed premium VL product development has sharply declined in favor of VUL. Today's variable product designs frequently resemble those of mutual funds. Recent variable annuities and variable life products have moved to back-end load (surrender charge) and asset fee designs. The shift to back-end load products is largely a response to competitive market conditions. In addition, variable products are sold through distribution channels, such as stockbrokers, that are accustomed to selling back-end loaded products.

Single premium variable annuities (SPVA) and single premium variable life products have recently dominated the variable marketplace. This year, some insurers have delayed development of a VUL product until their single premium variable life was completed. Reasons for this current popularity include:

- SPVLI's and SPVA's current tax-sheltered advantages cause them to be more attractive than many other deposit institution products;
- "Fire sale" marketing approaches are being used, since these tax advantages may be short-lived;
- Certain single premium products can be easier to administer;
- Maturing certificates of deposit, which could only be reinvested at low current interest rates, have been sources for premiums in many single premium variable contracts.

Many current SPVLI product designs permit the policyholder to pay additional premiums under certain conditions. This flexibility offers competitive advantages to the insurer. Another reason for permitting additional premiums is that the contract may qualify as a flexible premium contract. A flexible premium life contract can deduct higher maximum annual mortality and expense risk charges (deductions for mortality and expense guarantees) of .90% of the fund versus .60% for fixed premium plans. It appears that the SEC will consider a SPVLI contract to be a flexible premium contract if the policyholder has the contractual right to pay an initial premium as low as 80% of the guideline single premium. Legal counsel familiar with SEC issues should be involved in designing these features.

The foundations of VUL, SPVLI and variable annuity contracts are the individual funds which determine the policyholder's cash values and death benefits. Insurers continue to diversify the types of available funds. Beyond the typical money market, stock, bond, general and managed accounts, separate accounts now include high yield bonds, aggressive growth stock, gold, zero coupon bonds (of different maturities), real estate, and international funds. We expect this expansion to continue as insurers try to market at least one "hot" fund at any time.

Variable annuities and variable life contracts permit transfers of monies between funds. The trend is toward an unlimited number of transfers without transaction charges. Sometimes, the first few transfers are free, and any additional transfers are levied a charge of $10 to $25. Actual experience so far has shown little transfer activity. At the time of this

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writing, we have begun a study on the changes caused by the recently increased volatility in the financial markets.

Variable annuity and variable life contracts deduct charges periodically from the fund to cover certain risks and expenses. Charges are expressed as percentages of the fund value (asset-based charges), a flat dollar amount, or as an amount per $1,000 face amount for life policies. Asset-based charges, which are becoming more common, allow the charge to increase over time as the fund value increases. Typical deductions are: the mortality and expense risk charge (M&E charge), a charge for the mortality and expense guarantees in the policy; the investment advisory fee, a charge for management of the separate accounts; and the administration fee, a charge for the administration of the contract. In addition, some products assess cost of insurance and premium tax charges in the form of an asset fee. This is especially true when financial institution representatives are involved. The SEC currently limits the annual M&E charges to .60% of the fund for fixed premium variable life, .90% for flexible premium variable life, and 1.25% for variable annuities. The investment advisory fee is often set equal to the charges assessed the insurer by the investment manager. Consequently, the insurer often does not profit from this fee.

Some contracts deduct front-end loads, expressed either as a percentage of premium, $*X* per $1,000 face or $*Y* per policy in the first year. SEC requirements that issue and administration charges be cost-based restrict the levels of these deductions. Front-end loads have been declining in popularity.

Variable life contracts also deduct charges for the cost of insurance (COI) benefits and the cost of any minimum death benefit guarantee. COI charges usually are defined on a maximum guaranteed rate and current rate basis, and frequently vary by sex and smoking status. When COI charges are fund based, they can vary by age, sex, and smoker classifications to avoid gross profitability inequities between classes. A minimum COI charge is sometimes defined to maintain profitability.

In designing variable products to resemble investment vehicles, attempts are made to minimize the amount of life insurance. Variable annuity contracts generally provide a death benefit equal to the greater of the fund value and premiums paid. Like universal life, VUL contracts offer a choice between Option A and B death benefit patterns. Many variable life products use the guideline premium test to reduce the present value of the death benefits. Insurers can reduce death benefits by using higher guaranteed mortality charges in the guideline premium calculation. However, mortality charges exceeding 1980 CSO rates have been treated as sales loads by the SEC for standard medically underwritten policies.

The SEC does, nevertheless, permit use of guaranteed COI charges greater than 1980 CSO rates if simplified issue underwriting is performed. Although not all states permit use of this higher mortality, the net amount at risk can be reduced significantly. Accordingly, many products are being designed assuming simplified underwriting and guaranteed COI charges of 125% or more of the 1980 CSO rates.

Insurers have also attempted to reduce death benefits in the guideline premium calculation by deducting certain asset-based charges from the gross interest rate defined in the tax code. For example, some insurers deduct administrative and other charges expressed as an annual percentage of the fund from the interest rate used in the guideline premium calculation. This lower interest rate yields a smaller death benefit per $1 of premium. Tax counsel must play a key role in assessing the advisability of these interest rate adjustments.

A joint and last survivor variable life product, which pays a death benefit upon the second death of two joint insureds, has recently emerged. The death benefit on such a product is funded by COI charges which are significantly smaller than for a single insured plan. An added advantage is that the tax deferred benefits extend over the lives of two people. These products reflect the increasing investment orientation of the new variable designs.

Guaranteed minimum death benefits (GMDB) are available on some variable life plans. The benefit is usually designed in one of two ways. The first provides that the death benefit will never be less than the original face amount, although the policy could lapse if investment performance is poor. The second provides that the contract will provide a death benefit regardless of the investment performance. For this latter guarantee, many insurers deduct a separate GMDB charge from the fund and hold separate GMDB reserves. GMDBs are more likely to be offered on products sold through life agents than products geared for stockbrokers.

Statutory and tax reserves for variable products have not yet been defined by either the NAIC nor the IRS. Insurers are currently holding statutory reserves which they feel are suitable for their own situation. The full fund value and the cash surrender value are common. Individual insurers' surplus and tax positions are important concerns in establishing these reserves.

Policy loan provisions vary widely, but the "net wash" loan feature found in general account single premium policies is usually absent from SPVLI contracts. This is caused by the loss of the M&E charges and administrative charges on loaned amounts, since loaned amounts are transferred out of the separate accounts and into the general account when a policy loan is requested. The transfer of loaned amounts to the general account will remove the policyholder's investment participation in the variable accounts. Therefore, a fixed account product would be more appropriate if heavy loan utilization is planned. Recently, however, more new SPVLI plans are offering "net wash" loans.

The kinds of design features we can expect in the future will depend on market and regulatory environments. The development of group variable products is beginning in some companies. One fact is for certain—as competition becomes more fierce in the future, product development actuaries will continue to search for new ways to create innovative variable product designs and investment choices.

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In Memoriam

Francis T. Driscoll F.S.A. 1966
G. Kingsley Fox F.S.A. 1950