A Case for Variable Life

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Abstract: *Will variable life surpass general account products as variable annuities have overtaken fixed annuities? In spite of the sales success in the affluent and corporate markets, there is vocal opposition to variable life. This article examines some of the main contentions, such as: (1) variable life is too risky for most clients, and (2) it is much more expensive than general account products. The analysis of this article shows these arguments are not based on empirical data, but on assumptions and preconceptions. According to the author, the variable life product will continue to grow as agents, customers, and advisers understand the differences.*

In 1994 and 1995, variable life accounted for almost 20 percent of U.S. life insurance sales, growing from 6 percent just three years earlier.[1] This growth has occurred despite increased compliance concerns, the small number of companies offering the product, and only 60 percent of licensed life insurance agents also holding a securities license. Even with these constraints, many observers predict that variable life may some day account for 50 percent of all sales. Such a benchmark would be consistent with industry variable annuity/fixed annuity product mix and life sales in the United Kingdom. In spite of these obvious trends, or perhaps because of them, there are sectors of the industry that resist the product and mistakenly dismiss it as a current gimmick. Fundamental differences between general account products and variable life products will cause an increasing share of the market to go variable in the years ahead. This article addresses the differences between the products and also refutes some of the misconceptions about the variable product.

Advantages to the Policyholder

The principal advantage to the policyholder is the potential of better product performance through allocation of part of the cash value to equity investments. Because of statutory regulations, rating concerns, risk-based capital requirements, and guarantee structures, the general accounts of life insurance companies are allocated 90 to 95 percent to fixed income instruments such as investment grade bonds and government backed residential mortgage pools. Wary of the danger of rising interest rates, most companies are keeping their maturity on these instruments to less than ten years. As of June 1, 1996, a typical AA bond with a seven- to ten-year maturity yielded 7.0 to 7.5 percent.[2] A comparison of this yield and the historic yields on equities show 280 to 330 basis points off the historic return of large cap stocks and 480 to 530 basis points off small cap stocks.[3] This information alone explains, to a large degree, why sophisticated financial advisers and clients have moved to separate account products (see Table 1).

A second and often overlooked advantage is the ability to customize a portfolio of subaccounts to match the policyholder's risk/reward profile. The dynamic nature of the product will allow this allocation to change over time and adapt to changing investment trends. If there were a repeat of the high inflation of the 1970s, the policyholder could reallocate a portion of the cash value to a high-yield money market subaccount.

A third and equally powerful advantage to the consumer is the separate account nature of the variable product in the event of insolvency. Several giants of the life insurance industry have faced downgrades, and even complete failure, during the past five years. Consumers who seek safety have no solace in knowing that their company was AAA when they purchased the policy. A well-known former executive of Executive Life commented that, "The rating of the company is not so important when you buy the product as when you need your money."[4] The rapid change that is occurring in the world economy should cause the prudent client to ask, if this is a 40-year transaction,

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what are the possibilities of any company maintaining financial strength over such a long period of time?

Variable life, while no panacea, certainly offers the policyholder additional protection if things go wrong. While contractual premium and death benefit guarantees may be altered in the event of insolvency, variable life accounts are separate from creditors and are accessible by policyholders. It can be further argued that a company with a large block of variable life is also less likely to experience a "run on the bank." This is because policyholders who know they can access funds are less likely to panic than ones who fear, or who are persuaded to fear, loss of access to funds in the face of adverse publicity.

The policyholders of several established companies may bear silent testimony to failures that were avoided. The strong variable product portfolios of these companies contributed to the retention of their sales force and assured policyholders in the midst of adverse publicity. The variable life product fairly distributes the risk of market fluctuations to policyholders because adjustments in market value in underlying investments are attributed to specific subaccounts. Only those policyholders who chose the Latin American Subaccount were hurt when they decided to withdraw after the financial crisis in Mexico. Contrast these circumstances with the failure of general account products from companies like Executive Life, Fidelity Mutual, and Confederation Life, where the policyholders and agents who did not panic were, in essence, penalized for those companies' poor investment decisions. Those who acted quickly to cash out, however, were rewarded.

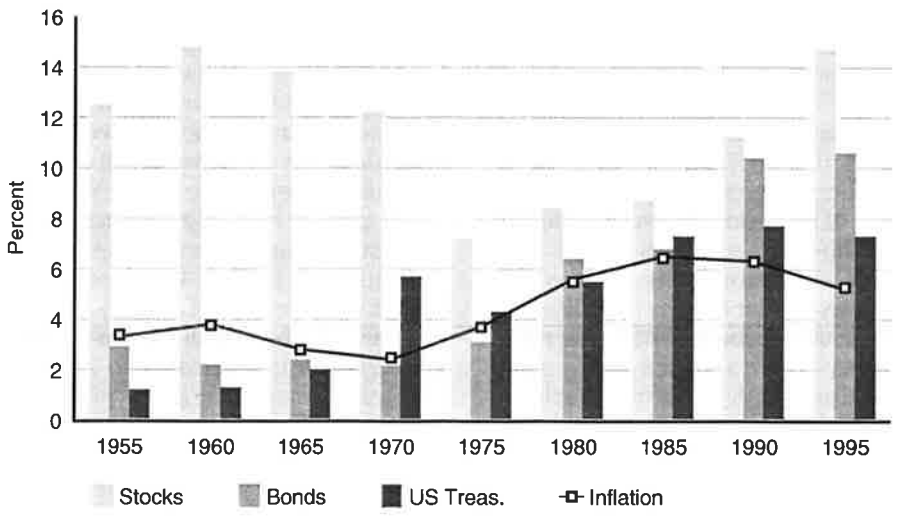
Several commentators have complained that variable life is a product ripe for a new wave of consumer dissatisfaction because of unrealistic ledgers and the variability of returns. Just the opposite, however, is true. In the last ten years, variable life is the only U.S. cash value life insurance product that has not failed to meet consumers' expectations. The greater disclosure in the ledger, the prospectus, and the control of sales materials by both companies and broker-dealers provides consumer protection and promotes a meaningful dialogue on how future investment and mortality performance will impact the ultimate pricing of the policy.

With this said, current methods of showing consumers how the product works must change with variable life. It has been pointed out — correctly — that the linear return of, say, 10 percent, does not give the consumer a realistic view of how a product would actually perform if the mean return was 10 percent (but this return has considerable volatility).[5] While illustrations need to adapt to meet this new challenge, the true culprits are the practice of minimum funding and targeting a premium.

Advantages to the Professional Agent

The custom of comparing prospective ledgers has been one of the most damaging practices in terms of industry and agent credibility. It has led a whole generation of agents, consumers, and companies to buy, sell, and design products that initially attract and then disappoint policyholders. The new NAIC model illustration guidelines bring to general account products a discipline that has long existed in the variable product — discussing the impact of different returns based upon what the consumer pays. Implicit in the variable product is the idea that actual investment performance will dictate both the costs and benefits to the policyholder. From an agent's point of view, variable life

TABLE 1
Average Annual Returns
20 Year Holding Period



Source: Ibbotson Associates

removes the game of "Can you top my ledger?" Variable life brings the consumer and the agent face-to-face with the reality that lower projected premiums or higher values are a pure trade-off with higher risk. The professional agent can use this fact to build a case for a variable product structured with significant guarantees and projected at realistic rates.

Variable life creates more sales and better-funded programs, resulting in more income to the agent. Variable products also create a greater client involvement in the buying process. The client understands and is more interested in the historic return of a subaccount than in which company has had the highest divided history for a 35-year-old male who purchased a $25,000 whole life policy in 1960. This results in higher premiums and more conservative design in separate account products, which have a premium that is 10.5 percent larger per thousand and a death benefit that is 40 percent larger than the average general account product.[6]

Variable life also creates the meaningful dialogue that professional agents long have sought with the companies they represent. The enhanced disclosure of a variable illustration combined with a 40-page disclosure document (a prospectus) leaves less room for the company that wants to play secret ledger games. The requirement of filing the document with the Securities and Exchange Commission creates the teeth to insure full disclosure. Recently, a producer thought he was being "out illustrated" by a competitor's variable life product. With just a little bit of digging, one could ascertain from the prospectus that this company was showing a 95 basis point reduction in annual charges at a point in the future. This projection of future efficiencies was also disclosed as being completely nonguaranteed. The logical questions to ask in such a situation are: (1) Is this reasonable given that this company's business has been off more than 50 percent in the last four years?, and (2) From where are these increased efficiencies going to come? The variable product does not completely eradicate ledger games, but it does eliminate a company's ability to hide them from a professional agent.

The variable life sale enhances the role of the professional agent. With a more complex product and expanded policyholder options, there is a real need for ongoing professional advice and service from an agent. Those who can adapt to this new paradigm will find that their value-added expertise will serve them well in an era of increased consumer choices and rapid industry change.

Advantages to the Issuing Company

For the company with the foresight, or luck, to have invested significant resources in developing a variable life product and distribution, there are several tangible rewards that enhance the company's financial strength. First, the company knows it can earn a predictable spread on the products it manufactures. General account products are priced for a certain spread. However, actual changes in interest rates and competitive pressures to keep market share often result in lower returns.

Second, in an era of low interest rates, the two-headed dragon of disintermediation and policyholder withdrawals is a real concern. Traditional products put the company at risk if interest rates spike upward again, as in the 1970s, and policyholders consequently move money to higher-yielding investments. An influx of policyholder withdrawals, combined with a bond portfolio that is under water, could quickly wipe out even a significant surplus.

A third advantage of variable life is a reduction in the risk of large judgments against insurance companies. Disputes involving securities are often arbitrated by National Association of Securities Dealers' (NASD) arbitrators rather than being litigated in front of a jury. Because variable life is treated as a security and marketed through NASD broker-dealers, the cost of resolving disputes is lower, and judgment is more likely to be confined to actual damages rather than multimillion dollar punitive damages. In short, the federal jurisdiction of security law is preferable to an unpredictable state court decision.

Finally, in most states, there is no assessment under the state guarantee pools against a company for the variable premiums it has written. Under most state insurance guarantee pools, each solvent company is assessed its share of the clean-up cost of the failed life insurers based on the premiums it has written. Because they are not within the reach of creditors, variable life products are not required to carry the costs of irresponsible and reckless companies no longer in the business.

Nevertheless, many companies are not well-positioned to offer variable life. Small companies, companies with an unsophisticated sales force, and companies with a brokerage or personal producing general agents (PPGA) distribution are all but blocked from offering a product. The broker-dealer/registered representative relationship is a monogamous one. Late entrants and companies without an existing variable product offering face severe handicaps in the critical mass to market variable life profitably. As recently as 1987, there were only nine carriers offering a variable life product.[7] The variable life trend also favors larger companies that have an economy-of-scale in manufacturing and distributing a variable life product. These twin impediments — not having distribution through a broker-

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dealer and lacking critical size — have locked out many U. S. insurers from the variable life boom. As of 1994, the last year for which data was available, 15 companies wrote almost 75 percent of the variable life premiums in the United States.[8]

Three Major Misconceptions

With all these advantages to consumers, agents, and companies, one might wonder why variable life does not account for a majority of the product sales in the United States like it does in the United Kingdom. Much of the answer goes to the historic segregation and regulation of the U.S. financial industry. Historically, the United States has had high walls between equity brokers, insurance companies, and banks. As these walls have come down, the insurance industry has been slow to respond to the deregulation. The U. S. life insurance industry tends to trail the financial markets. The aging and declining population of traditional agents may privately resist the product because of lower compensation and greater control by the companies in the sales process. However, their public longstanding objections fall into three categories: (1) the product is far too expensive for the consumer, (2) the "added" charges in a variable life contract increase the cost above general account product costs, and (3) it is too risky for most people. Are these criticisms valid ?

Is Variable Life Too Expensive?

Cost is the most frequent criticism of the variable product. Many agents and companies not offering variable life to their clients make generalizations like, "Compared to general account products, the policyholder would have to earn an additional 300 basis points to justify the purchase of variable life." As the data that follows indicate, this perception is based on misinformation and anecdotal evidence. Such statements justify the NASD rule prohibiting this type of comparison. The comparisons are flawed for several fundamental reasons.

Net Versus Gross Rate. First, many such comparisons are based on comparing a gross rate to a net rate. In other words, with general account products, the company buys the 7 percent bond and credits 5.75 percent. It allows for a spread on an undisclosed difference between what the bond earns and what is credited in the product. However, in a variable product, the consumer earns a return on a portfolio that he or she selects and the company earns a "fixed spread" on those assets. A comparison using the same interest rate in a separate and general account ledger gives an unfair and misleading 100 to 150 basis points illustrated advantage to the general account product. Actuarial figures from three separate companies show that the pricing difference between their general account products and variable products is in the neighborhood of no more than 30 to 50 basis points.

Low-Cost Versus High-Cost Subaccounts. Second, many critics of high-cost subaccounts point to particular variable products that may not be representative of the group as a whole. Several comparisons point to products with a name brand asset manager. This type of comparison, in essence, is selecting the *highest cost* product for comparison, and is akin to concluding that motorcycles are more expensive than cars because the price of a used Yugo is less than that of a new top-of-the-line

TABLE 2
Typical Subaccount Management Charges

	Management Fees	Other Expenses	Total Mutual Fund Expenses
A. Subaccount — Growth Fund/ Internal Management	0.44%	0.03%	0.47%
B. Subaccount — Socially Responsible Growth Fund	0.69%	0.58%	1.27%
C. Subaccount — Government Bond Fund	0.50%	0.01%	0.51%
D. Subaccount — Brand Name Growth Manager	1.00%	0.31%	1.31%
E. Subaccount — Real Estate Securities Fund	1.00%	1.90%	2.90%
F. Subaccount — Name Brand International Equity Manager	1.00%	0.44%	1.44%

Harley. Some variable products are very competitively priced with total charges over the general account ranging from 30 to 50 basis points. Others have a relatively high cost because they must not only earn their own traditional spread, but also must compensate the name brand managers. Thus, the variable market can be divided between the products targeting reasonable cost and those appealing to consumers based on name brand subaccounts, which can add as many as 100 to 125 basis points annually to the cost (see Table 2). Many companies, late into the variable life market, were forced to adopt the second strategy because of a lack of an internal track record. They have tried to create a perceived track record by adding "designer labels." Thus, their cost structure has not yet reached an economy of scale.

Table 3 is a summary comparison of three companies that market both a competitive general account flexible premium product and a competitive variable flexible premium product. For comparison purposes, an additional product called the "Sparkle and Glitter" is included. Companies A, B, and C all have over $1 billion under separate account management and competitively priced subaccounts. "Sparkle and Glitter" is comprised almost entirely of name brand subaccount managers. All comparisons are for $1 million of coverage on a male, age 40, nonsmoker, with a relatively high premium being paid all years to age 100. The companies all have the same underwriting for both their general account and variable products and pay a similar commission on similar target premiums.

The methodology used in this comparison was to first run the general account products at their current interest rates, thus producing a projected cash value at age 100. The same premium was then paid into this same company's variable product. The variable life ledgers were run to produce an identical projected terminal cash value. In essence, the illustrations were run to solve for the gross interest rate in order to provide cash values at an identical projected age 100. This process was repeated for all three companies. There was initially a difference of between 230 basis points and 136 basis points with the advantage to the general account products. However, this contrast can largely be attributed to the difference between *gross* and *net* rates (see Table 3).

Comparisons of high-cost variable life products versus general account products are not trustworthy. While name brand subaccounts carry marketing sizzle, they come at a cost. In the limited comparison in Table 3, a 175 basis point differential exists between variable life products. Comparisons between high-cost variable products are essentially against a straw man. Competitively priced products do exist, and an internal comparison within a company's lineup is the only fair basis for comparison. The limited analysis above confirms the actuaries' statements showing competitive variable products only at a 30 to 50 basis point disadvantage in pricing over their general account sisters.

Minimum Premium Comparisons Magnify a Small Pricing Differential. Those who have worked with computer generated ledgers know that the idea of targeting a UL premium to produce a cash value equal to the death benefit at age 100 is a dangerous and volatile way to present *any* type of life insurance. A small change in interest rate will change the product from one that "endows" to one that "crashes." In essence, minimum funding magni-

TABLE 3[1]
Comparison of Net Crediting Rates UL Versus VUL [2]

	General Account Universal Net Rate	Variable Universal Gross Rate	Variable Universal Net Rate	Additional Projected Cost to VUL
Company A[3]	6.50%	8.80%	7.29%	0.79%
Company B	6.00%	7.36%	6.17%	0.17%
Company C	5.25%	6.77%	5.18%	-0.07%
Sparkle & Glitter Life	—	8.54%	5.69%	
Additional Cost of *Sparkle & Glitter* over efficient variable life[4]				1.77%

Notes:
(1) All comparisons make no judgment on the reasoning of other charges, including mortality costs.
(2) All products run on male, age 40, $1 million face amount. Premium paid all years.
(3) Actual difference between net and gross rate lower UL product has 31 basis point interest kicker after year 10.
(4) *Sparkle & Glitter* run to solve gross rate needed to equal targeted cash values of Company C VUL at age 95.

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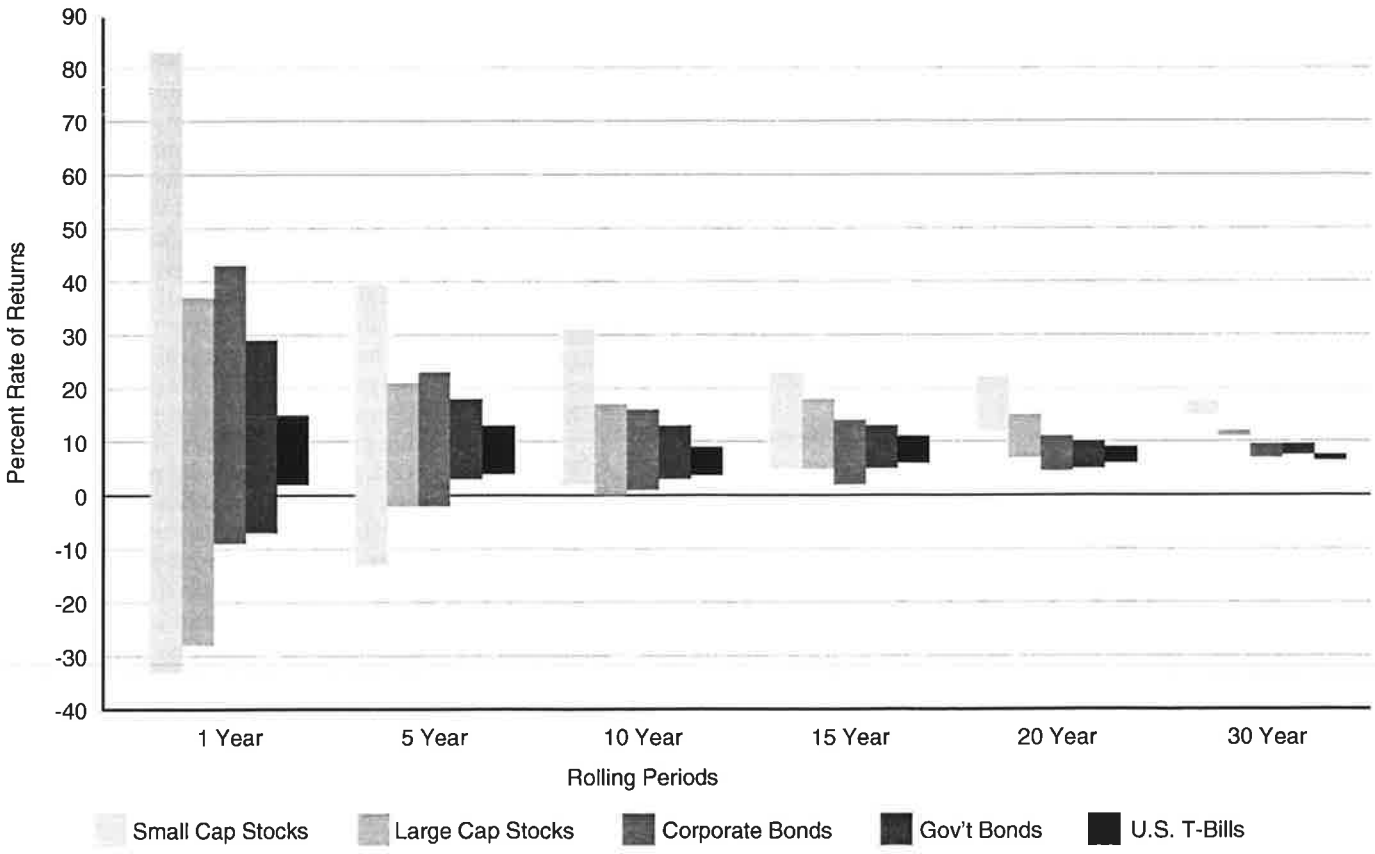
fies small differences in projected product pricing. Therefore, it is not surprising that these types of comparisons, with the differences outlined previously, and even with the real 30 to 50 basis point difference, would produce an exaggerated result.

Policies structured in this manner are fraught with potential for abuse and offer the greatest likelihood of policyholder dissatisfaction. This type of funding structure should be avoided in all products, but especially in variable life. Producers who wish to establish and maintain a high degree of professionalism and success help their clients understand the volatility of minimum premium funding and implement designs with much better stability. "Insurance pros" do not sell minimum funded plans (general or separate account) because they know in all likelihood the policyholder will be dissatisfied.

Multiple Charges in a Variable Product Make It Noncompetitive

There is the perception that a multitude of charges found in the variable life prospectus are not present in general account products. The corresponding perception is that variable products have higher total charges than the undisclosed charges in traditional products. Because variable life is regulated as a security, each charge

TABLE 4
Range of Returns
Rolling Period Returns Using Ibbotson Asset Class Information*
(1960 through 1995)



Source: Ibbotson & Associates

must be detailed and disclosed. The year-end confirmation statement to the policyholder/investor must account, to the penny, for the premium and existing cash value. General account products need only to disclose guaranteed year-end values. No accounting or disclosure is required to say how the initial premium translates to these values or what amount went to each expense. Apart from the higher development costs, all three pricing actuaries cited earlier indicated there was not a considerable expense differential between their fixed and variable life lines.

In designing a variable life product, there are many limitations in terms of the charges a company can impose. Therefore, design often involves internally trading expenses in the company. The 1933 Securities Act and many subsequent regulations did not anticipate variable life insurance products. The relatively recent development of the product in the United States has meant that actuaries have had to trade off expenses internally to "shoehorn" the product to meet regulations. For example, the traditionally high costs of a company acquiring and underwriting a product are out of line with the specific sales load limits under the Security and Exchange Commission Rule 6e-3(T).[9] Therefore, actuaries must reconfigure costs to give a result that is very similar to loading and expenses in a traditional product while still complying with complete disclosure and limits on individual charges.[10]

Variable Life Products Are Too Risky

What is risk? This basic question must be considered to adequately address the perception that variable life products are too risky. If one of the very real risks is that cash value may rise or decline 30 percent or more in a given year, is this a problem? If one believes the long-term equity markets will continue to outperform bonds by 300 to 400 basis points annually, then the policyholder is harmed only if he or she "cashes out" in a down market. If life insurance is indeed a long-term purchase and the policyholder adequately funds the policy, temporary market corrections should be of relatively little consequence. It also makes sense to ask, for what is the cash value used? If it is used to support a death benefit over a lifetime, why not back the policy with assets that are long-term investments? When planning for their pension, many clients choose equities because of the long-time horizon until age 65.

For a properly constructed life insurance policy, the time horizon is even longer. Table 4 demonstrates that, historically, the variation in equity performance decreases as the holding period increases. While past performance of equity markets is not necessarily a predictor of the future, these historic trends certainly make the point that there may not be a more consistent and logical application for equities than in a life insurance contract.

The misconception that variable life means 100 percent equities is another problem with the perceived risk of variable life. The fact that allocation can and should change over a policyholder's life cycle is actually an advantage. Once the misperception of high expenses is removed, it makes sense to allocate cash values in a way that mirrors the policyholder's risk tolerance and optimizes long-term return. The policy allocation can and should change over time.

The debate between separate account and general account products is not a choice between no risk and high risk; it is a choice between different risks. General account products carry the risk that at some time over the next 30 or 40 years a CEO may make bad decisions leading to insolvency and no access to values, that the company may arbitrarily reduce interest rates or dividends, and that inflation will seriously erode the current value of the cash value or death benefits. Variable products have different risks. There is a risk that the particular allocation may earn more or less than the historical norm; there is a risk that fluctuating returns will have a result that is different from a straight return; there is a real probability that the cash values may fluctuate widely; or there may be a prolonged period where the stock market will not do well. When given all of the information, many informed agents and clients will choose the latter risks over the former.

The future is bright for companies, agents, and policyholders who can adapt to this changing paradigm. Variable life is not a passing fad, but a watershed change that shakes the core of the life insurance industry, its products, and its distribution. **J**

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(3) Ibbotson and Assoc., Stocks, Bonds, Bills and Inflation, Summary Statistics 1925-1995, (1996).
(4) Gary Schulte, Presentation at Minnesota Mutual Seminar (Feb. 20, 1995).
(5) Michael Brennan, *Helping Clients Understand Behavior of Variable Life*, Nat'l Underwriter, Sept. 2, 1996, at 7.
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(8) A.M. Best Policy Reports, 27 (Dec. 1995).
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(10) IIR Fourth Ann. Ind. F., Variable Universal Life Congress (Feb. 27, 1996).