**TRANSACTIONS OF SOCIETY OF ACTUARIES
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Policy Replacements

A. What information is available on the extent of policy replacement abuses? What steps have individual companies taken to control replacements of existing policies? What procedures have companies adopted to meet the several state regulations regarding replacements?
B. What form of replacement commission rules has proven to be effective in controlling replacements and at the same time fair to all parties?
C. What type of demonstration has been helpful in analyzing the effect of a proposed replacement on the policyholder's interest?

MR. JAMES G. BRUCE: I have the impression that there are many cases of abuse in policy replacements. Unfortunately, there is no definition of abuse that I know of. Much circumstantial evidence can be obtained by examining individual cases, but it is often difficult to produce proof.

I wonder why we try to determine the extent of the abuses when we are generally agreed that many replacements are harmful to policyholders. I believe that we should make replacements such a difficult process that they will be undertaken by agents only after much consideration.

In 1958 the Hartford Life, then the Columbian National, sent instructions concerning replacements to all general agents and branch managers. These instructions specified that in any case where an exchange might be proposed a full comparison of the advantages and disadvantages of the existing and proposed policies must be given to the policyholder. We are just about to issue a new statement of policy for our company, based on the ideas that have been expressed in the new regulations of eleven states concerning replacements. We intend to make this policy applicable in all 48 states in which we do business.

We want our rules to ensure that no incomplete comparison of policies of this or any other company will be made to any person for the purpose of inducing him to lapse, forfeit, surrender, or use the cash or loan values of his existing insurance. However, we do not want to provide a form that will purport to produce a complete comparison.

Instead, we are now working out an elaborate check list, and we will take the position that a comparison is incomplete unless it compares in detail all items listed on the check list. In addition the check list will stipulate that any further comparisons that are necessary should be made.

We are going to try to put teeth in this official policy by insisting that one copy of the proposal and comparison be retained by the agent for three years, one copy sent to the home office with the application, and, in those states where required, one copy sent to the Insurance Department.

These comparisons will be screened, and where it can be shown that it is not to the policyholder's advantage to make the change, we will make our suggestions and hold up issue until the policyholder acknowledges our comments and reconfirms his desire to go ahead with the change.

However, I am sure that we will not be able to enforce this decision unless the majority of companies take similar action.

We also intend to revive a practice we once followed, of notifying the other company in replacement cases, so that they can take steps to conserve their business.

I think that full information to the public and a determined effort on the part of all companies can solve this problem, but surely no idealistic company will be able to solve it alone.

MR. CHARLES A. ORMSBY: As far as I know, there is little, if any, significant statistical information helpful in relating the magnitude of the replacement problem to the number of policies exposed to this type of termination.

Over the past few months, the underwriting department of the John Hancock has maintained a summary card for each new business application where there was admission of an intended replacement. Unfortunately we do not have a standard of comparison, such as a measure of the replacement problem which existed in the thirties, against which to check our current experience.

While we cannot as yet state precisely the extent to which replacement abuses may exist in our own Company, from our summary cards we do know what is being replaced and why. The circumstances under which replacements are being sought do give us some insight into the general nature (if not the extent) of the problem. The following classes of policy replacement were brought to our attention:

1. First, I would list the replacements of term insurance, usually that of other companies. It seems to be generally agreed in the industry that replacing term insurance with no change in underwriting classification does not usually constitute a serious abuse of the policyholder's privileges, provided state regulations do not dictate otherwise. However, even this practice should be closely watched for possible unforeseen developments.
2. Our second subdivision consists of replacements of regular permanent forms of insurance by another regular permanent form. In some instances, these involve policies originally written by the John Hancock; in others, the policies of competing companies. In either case, this is the kind of replacement where it is generally agreed that serious abuses apparently do exist. It is in this type of replacement that substantial financial losses can be incurred by the insuring public, primarily because of the duplication of sizable acquisition expenses. This is where actuaries can perhaps best employ valid cost com-

parisons to persuade the policyholder that he should not proceed with the proposed replacement. Moreover, this is the area where the companies have, over the years, worked together so that the company which wrote the policy being replaced receives early notice of the impending transaction and is given an opportunity to discuss the matter with the policyholder.

To me, the most interesting aspect of this subdivision of our replacement problem is that all too often comparative cost figures which are convincing to us are not so convincing to the policyholder. However much we may be impressed by what we consider to be strong financial reasons against replacement, the fact remains that in more than an occasional case the policyholder himself has other reasons, often not financial in nature, for concluding that the proposed replacement is worth while. In my opinion, many of our problems in this subdivision have resulted from changes in our products since issuance of the policy being replaced. These changes in policy provisions or pricing reduce the effectiveness of the cost comparisons which we use to discourage replacements.

3. Another subdivision of the problem consists of those replacements of permanent insurance with either a cheaper form of permanent insurance or a term plan. Here the trouble seems to be that the policyholder has lost some faith in cash value life insurance and has decided that he wants to reduce his investment in life insurance as much as possible so that he can put the released cash values into mutual funds or similar investments. This part of our problem is to a great extent created for us by economic forces outside the life insurance business and requires measures on our part to combat such a philosophy by re-establishing in the mind of the insuring public the attractiveness of cash value life insurance.
4. A fourth subdivision is that where regular permanent forms of insurance are being replaced by the family policy. This is perhaps our best example of the introduction of a new policy form so different from anything offered previously that a situation is created where the policy being replaced and the replacing policy are far from being comparable in many important respects.
5. There is also that subdivision consisting of pension trust policies being replaced by group coverages or by an uninsured plan. Most of the examples I have seen in this category have to do with pension trusts which were small enough for individual policies initially but which have acquired over the years such a large number of participants that group coverages may now be considered more appropriate. This part of the problem can be solved in a fairly satisfactory manner by offering the employer comparable coverage under group contracts and transferring the funds accumulated under individual policies to the group department.

Classifying a representative cross section of current policy replacements should be helpful to us in devising appropriate remedial measures. If the recent experience at the John Hancock with this multi-faceted problem is representative, then it seems that what is needed is a united campaign against replacements which takes cognizance of the many different subdivisions of the entire problem. We should be able to solve or mitigate the replacement problem by:

a) Using a premium stuffer to alert policyholders to the general disadvantages of replacements of permanent forms of insurance and to suggest that the company be given a chance to offer comments in the event a replacement is recommended.
b) Continuing to resist replacements which are not in the policyholder's best interests. One form of resistance is the special commission schedule referred to in section B. Another form is the requirement of a clear and complete statement of the advantages and disadvantages of applying for new insurance to replace the old.
c) Stressing the need among our agents to sell the right contract in the first place. We cannot ignore the fact that some replacements are due to something less than the best sales presentation initially.
d) Bearing in mind ourselves the need to make available to existing policyholders, insofar as is feasible, the improvements and liberalizations which are offered in connection with new policies.
e) Promotion of the philosophy of the value of cash value life insurance from a long-range point of view.

In reviewing the various forms in which the replacement problem currently appears, it is sad indeed to note that to some extent we ourselves have created the conditions and the attitudes which are conducive to replacement activity. I am sure we shall continue to be faced with a serious replacement problem so long as we apply our ingenuity to designing new products and refining old products for new issues without giving considerable thought also to sound and practical ways by which the contracts of existing policyholders can be modernized and liberalized in a corresponding manner. We cannot afford to have existing policyholders feel they are a forgotten group whenever we introduce new products or prices to the insuring public.

MR. DOUGLAS S. CRAIG: The Metropolitan has taken a strong stand on replacements for at least 50 years, and has established rules for our agents to observe. For all this time there has been a question in the Ordinary application to determine if a replacement is contemplated, and if the answer is in the affirmative, we notify the other company. We also require an explanation from the agent.

The problem of replacements has been with us for a long time, although some articles recently published might suggest that the problem was of recent origin.

I believe that all these new state regulations are a very good idea, and

I hope they will work, not merely drive the twister underground. But we need to have the will to make them work.

MR. THOMAS E. GILL: In the London Life we have controlled replacements within the company with some degree of success through our replacement regulations. We adopted the principle that where the company has paid a first year commission to establish a premium income on its books the company has a right to expect the premium income to be maintained and, if replaced, the agent should be entitled to commission on only the increase in premium income. Also, where an agent has a choice of reinstating or maintaining old business or writing new business, it should not be more profitable for him to write new business.

For a number of years we paid only the increase in commission, if any, where a policy was surrendered and a new policy was issued, if the surrender occurred before the policy had been ten years in force and if the surrender was within six months prior to or six months after issue of the new policy. Similarly on lapses there was a full replacement charge where the new policy was issued within six months prior to or six months after lapse. In order to catch these replacements we have a replacement file where we match new issues against terminations. The cards are maintained in the file for a period of about eight months.

We made a survey of all terminations during the month of March 1960 on policies in force 15 years or less. We found that most surrenders for cash occurred close to the date of issue of the new policy. Also, cash surrenders replaced by new insurance increased sharply in the eleventh policy year. In the twelfth policy year there were still quite a number of replacements, but only at about half the eleventh policy year rate. After the twelfth policy year the number of replacements was relatively small. There were very few policies lapsed within the first two years associated with issue of additional insurance and such lapses were concentrated within a few months following the issue of the new insurance.

As a result of the survey we extended the replacement charge from ten years to twelve years, but graded the charge downward from the ninth year on.

No exceptions are made in applying our replacement rules, and we believe these rules have helped to give us a relatively good record on replacements within the Company.

MR. FREDERICK E. RATHGEBER: For many years the Prudential has followed the philosophy that an effective way to control replacements is to adjust first year commission to the writing agent of a policy which replaces another Prudential policy. If there is an increase in premium income to the Company as a result of a replacement we pay full commission on the increase; on the amount of premium being replaced we pay no first year commission.

The replacement period for commission adjustment runs from three months before to three months after the issue date of the new policy for individual life insurance. For individual health insurance the same general rules apply except that the replacement period runs for six months before and after issue.

We have mechanical systems for matching records of lapses and surrenders against issue records. This matching is done on the basis of the insured life only and not on a family basis.

In the past we attempted to make replacement adjustments on a case basis for certain types of transactions but this arrangement turned out to be unworkable. We feel our present rules provide an effective control against excessive replacements and represent a reasonable balance between fairness to the agent and administrative feasibility.

Control of intercompany replacements is a much more difficult problem. We follow the notification requirements of New York's Regulation 39 for business issued in all states, not just New York. We also comply with replacement regulations issued by other states, but only for business issued in those states. Unless a uniform replacement regulation is adopted by the N.A.I.C., the rapidly increasing number of individual state regulations, each with different requirements and some with almost impossible requirements, can result in rather chaotic conditions.

MR. CHARLES F. B. RICHARDSON: I have been interested in the replacement problem for many years. Some years ago I made a study of the replacement rules of other companies and, while they looked fine on paper, I feel that in many cases, at least until recently, they have been honored more in the breach than in the observance.

While the problem has always been with us, it has become more acute in recent years for several reasons. One is the development of the credit purchase arrangement for new insurance. Another is the tremendously competitive market of recent years and the many rate changes that have taken place in the last 5 or 10 years. Also, there has been a great increase in the formation of new companies and they are all striving to get enough business to cover their overhead.

Another recent development should be mentioned: affiliations of life and casualty companies which are attempting to get life business through casualty sales organizations. This is and will be a real part of the problem, since the casualty man does not recognize a replacement as such in his own field.

We have just been through the problem of replacements within our own Company (Berkshire Life) as a result of a change in premium rates. We sought out these replacements and, while they were not as extensive as we feared, we have applied our replacement rules strictly. To help enforce the rules, we have set up a committee to review each case.

MR. RALPH P. WALKER: While studying the proposed Wisconsin regulations, some thoughts occurred to me that have not been expressed.

Adoption of replacement rules and notification of other companies may be helpful but will not cure the problem. For example, they will not prevent a mutual fund salesman from raiding our policies or from calling in another life agent to write term insurance to replace permanent insurance.

It seems to me to be more effective to require that the policyholder be given a comparison of the existing and proposed coverage, including a statement that the replacement may not be to his advantage, as required by New Jersey regulations.

We need to penalize the few agents who have been doing the twisting. Unless there is a proposal in writing, it is difficult to prove the intent of the agent and whether there has been misrepresentation. The question in the application with respect to replacement is also ineffective since, if a misstatement is made here, you cannot notify the other company. Hence, I believe we need state regulation calling for replacement proposals in writing, with some kind of penalty for the agent who fails to make a written proposal.

I feel the companies should try to promote regulations through N.A.I.C. or, failing that, through the individual insurance departments.

My main objection to the Wisconsin regulations is my belief that the primary responsibility in this matter should be placed on the agents and not on the companies. Forwarding the proposal to his own company puts the responsibility on the company, whereas I think it should be on the agent. Furthermore, I feel that you accomplish more by having the agent file a copy of the written proposal with the company which issued the business being replaced than by notification from the company writing the new insurance, because time is of the essence.

MR. WILLIAM F. SUTTON, III: The Penn Mutual has, for many years, had procedures under which potential replacements are handled. Where the replacement involves an existing policy in our own company the case is referred to an experienced policy change calculator and analyst so that he can compare the existing and proposed contracts. Where there is an indication that a Penn Mutual policy is to be issued to replace a policy in another company the case is referred to the agency department for review and notification of the other company. If we are notified that a Penn Mutual policy may be replaced by insurance in another company, the general agent concerned is advised and attempts to conserve the policy.

If an analysis of a replacement case initiated by one of our own agents indicates that an alternative approach, such as change of plan, would be preferable, issuance of the new policy is held up and a letter is written to the agent with our suggestions. The letter discusses the usual objections to replacements and gives basic cost figures. If we are not satisfied with the agent's initial reply we will often supplement our original figures with a more detailed cost comparison. If after this the agent is still convinced his client wishes to replace his existing insurance and we still feel the replacement should not be permitted, we will continue to withhold issue of the new policy until we have a written statement from the insured that all of the facts and figures have been presented to him and he still wishes to make the replacement.

In addition to reviewing all direct replacements we also try to control delayed replacements within the company. This is done by marking other policy records on the same life when a new policy is issued so that, if an older policy is surrendered or lapsed within one year, the file will be referred to a supervisor for review. If the new issue was in fact a replacement of the older policy, consideration is given to adjusting commissions or production credit.

A detailed comparison made in connection with a proposed replacement is generally a net cost analysis for equivalent death benefits over the next 5 and 10 years, and possibly a longer period. The analysis compares for the existing and proposed coverage gross premiums plus loan interest, if any, less dividends and less increase in cash value. However, there is no fixed pattern for such comparisons as they vary with the individual situation.

MR. RICHARD C. GUEST: One new development I noticed in some discussions of the replacement problem is a change in attitude toward replacement of term insurance by permanent insurance. The Massachusetts Mutual has followed the practice of intercompany notification on replacements since the early 30's, but never followed this practice in connection with term policies being replaced. I seriously doubt that an agent should be penalized for selling his client permanent insurance, when he needs permanent insurance, even though this may involve discontinuance of existing term insurance.

We have told our agents that they should in such cases point out the availability of a conversion allowance in the original company as well as the rerunning of the incontestable and suicide clauses in the new insurance. Parenthetically, they probably remind the applicant that the incontestable clause has no significance to an honest applicant.

I am not sure how much the replacement problem has changed over the years. Many individual cases are cited, but I have seen no comparative statistics.

An analysis of our own business over a six-months' period suggests there may be some misunderstanding as to the prevalence of twisting. Excluding the replacement of term, policies issued to replace other types of insurance amounted to less than 1% of our issued business, and about two thirds of these replacements are on the term or predominantly term plan replacing heavily loaned existing policies. From observations of transactions involving our own policies, we find that an additional 25% would cover those instances where related lapses have not been revealed. Hence, we believe that by alert handling of this problem we have succeeded in avoiding the development of any critical situation in our Company.

We make many calculations in our Company in connection with replacements in order to present an accurate comparison. Many policyholders with heavily loaned insurance prefer a new policy even though it may be a little cheaper to keep the old insurance. There is not necessarily a clear-cut answer to some of these comparisons.

We have published the replacement rules we are following and we do our best to make honest comparisons. However, we do not believe the comparison concept is enough in itself, since this might be justification for agents of a particularly low net cost company to replace large amounts of insurance of other companies without regard to other considerations.

MR. WILLIAM J. NOVEMBER: My own view is that we have a serious replacement problem which cannot be minimized. It is unfortunate that we do not have very much statistical information to shed light on this problem, but I believe there is sufficient evidence to show that policies are being replaced at a higher rate than formerly.

Our own experience (Equitable Society) shows that the termination rate for older policies has increased relatively more than the termination rate of recently issued policies. Thus in the case of policies more than five years old the termination rate has increased by about 75% over the rate that prevailed only a few years ago. The corresponding percentage increase for policies three to five years old was about half as great, while for policies within their first two policy years the increase was 20%. This is an indication that policies with larger cash values are being replaced at a relatively higher rate.

The current replacement problem may very well be one of our own making to a considerable extent. We have been pushing new kinds of coverage without values and have been offering provisions which enable a policyholder to take the values out of his policies and to replace them with term insurance. This suggests that policyholders are better advised to invest the values themselves, and this philosophy has been encouraged by some agents and by mutual fund salesmen. The rising stock market has also contributed to the problem. In my view this may have serious consequences for the permanent level premium insurance system, which we should be protecting with all our strength.

MR. JOHN C. MAYNARD: As mentioned by other speakers, the always complex problem of replacement has been further complicated in recent years by refinements in the pricing of insurance benefits, the most important new influences being size of policy, sex differential, and preferred underwriting. Another influence is the relation between the rate of interest which is used to discount premiums paid in advance and the rate of interest which enters the dividend formula; the former rate may depend on the rate available on new investments, whereas the latter rate depends on the average rate of the Company. The replacement problem has had one good effect in directing the attention of the companies to differences in treatment between new and old policyholders.

MR. STUART J. KINGSTON: My remarks will be confined to individual policy pension trust plans, an area in which policies have been subject to a higher degree of replacement than regular individual policies.

My impression is that many fine companies with high ideals are not opposed to replacement of individual policies of another company if those individual policies happen to be in a pension plan. While individual pension trust policies are frequently replaced by some form of group coverage, replacements by new individual policies are not uncommon.

In this area it is much more difficult to make a complete illustration to measure whether or not a replacement is justified. In addition to the usual mathematical features, there are other features of a pension plan which have to be considered before deciding whether the replacement is worth while. I will name just a few:

a) Guaranteed issue practices differ between companies, particularly with respect to increases in coverage and additions of new lives.

b) Features of the policy or practice of a particular company may suit the pension plan formula better than those of the company which originally wrote the plan.

c) The funding method desired may be more closely attainable through the individual policies or a group contract of another company.

d) Transfer of coverage to another company, even if there is a mathematical loss in so doing, may be considered worth while if increases in coverage and additions of new lives in the future can be handled more economically.

e) The ability of the agent to service the plan is extremely important. A pension plan may be transferred from one carrier to another because the agent of the new company and his home office are able to service the plan better.

Rules and regulations devised to date have very little application or effect in the pension field. For one of the reasons mentioned above, or for other reasons, the employer may decide to change from one insurance company to another. When policies are terminated and new applications are submitted to another company, the matter is generally too far advanced for the original company to do anything about it.

To summarize, I believe this field has been subjected to the replacement evil to a greater extent than the other fields, and very little thought has been given to corrective measures.