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DIGEST OF DISCUSSION OF SUBJECTS OF SPECIAL INTEREST

INDIVIDUAL LIFE INSURANCE

Interest

A. Is the generation interest rate approach applicable to (i) individual life insurance, (ii) individual annuities, (iii) supplementary contracts?
B. What would be the effect on dividend illustrations?

MR. BERT A. WINTER: For a possible refinement in dividend calculation procedures to be applicable to a block of participating business, there would seem to be two requirements. First, it should bring about a demonstrable improvement in the closeness of fit of the divisible surplus apportioned to the various dividend classes with the contributions to surplus made by such classes—that is, an improvement in equity. Second, that improvement should be large in relation to the administrative expense of obtaining it. In my opinion the generation interest rate approach, by this double test, is applicable to dividends for group annuities but not to individual policy dividends.

As to equity, the extent to which a policyholder's actions affect other policyholders is highly relevant. Under group annuities the amount and timing of payments to the insurer are presumably under the control of a sophisticated employer, while under individual policies such matters are essentially fixed by the contract. Group annuities generally provide controls on "cash-outs" and frequently relate the annuity benefits to the time at which they commence, while individual policies must provide statutory minimum nonforfeiture values and generally certain guaranteed settlement options not related to the time of settlement.

Individual policies of a given generation reach the paid-up or instalment settlement status at different times and, when they do, cause funds for investment to increase more slowly than the company average or to decrease, a situation which may lead, under the generation interest approach, to a lower dividend interest factor on such policies than on premium-paying policies with the same guarantees. This may well be regarded as undesirable. Presumably, corrective adjustments could avoid this result but make it more difficult to demonstrate that equity has been improved.

As to administrative expense, it is rather simple for a company to maintain a record of the year-by-year accumulation of funds under each of its group annuity contracts. On the other hand, in the Prudential we have not yet developed a practical system of maintaining retrospective asset shares for ordinary policies in the thousands of dividend cells for which the fund accumulation experience would appear to differ significantly in year-of-investment composition. This is hardly surprising, not only because of the sheer mass of the calculations but also because of the theoretical problems related to differing rates of growth of funds and to transfers of funds from one cell to another as the status of individual policies changes.

As to dividend illustrations, the assumption that current new investment yields will continue indefinitely would not only appear incredible in the light of past experience but would lead to illustrated dividends unsuitably greater than those currently payable at like durations, even if a generation interest approach were used for the latter. At the other extreme it might be assumed that the yield on new investments twenty years hence will be as low as it was twenty years ago. This would lead to an illustrated twentieth year dividend less than that currently payable under a generation interest approach.

In either case, dividend illustrations based on assumptions as to future yields on new investments might be regarded as "dividend estimates" prohibited by New York and other state laws. Under current conditions, it would appear proper to use for an illustrated dividend the earned interest rate used in the dividend currently payable at the same duration. Under other conditions, such as prevailed in the 1930's and 1940's, even this might be regarded as improperly optimistic.

In my opinion, consideration of dividend illustrations reinforces the arguments of equity and expense in leading to the conclusion that the traditional portfolio average method is superior to a generation interest approach for calculating dividends for individual policies.

MR. JOSEPH W. HAHN: I recently learned of a company which in new issues is guaranteeing, for a limited time, a dividend accumulation interest rate greater than that being allowed on previous issues. Illustrations of dividend accumulations for all years are based on this greater rate. If this is an application of the generation interest approach, then such approach makes dividend illustrations much, much better.