**TRANSACTIONS OF SOCIETY OF ACTUARIES
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DIGEST OF SMALLER COMPANY FORUM

INDIVIDUAL HEALTH INSURANCE

A. Are smaller companies able to develop sufficient premium income from health insurance without writing basic hospital policies in order to cover expenses of operating this line of business?

B. What success have the smaller companies had in sale of individual major medical plans? What reinsurance arrangements have been made to protect the small insurer? What has been the experience in this line?

C. What problems are involved in instituting rate increases on individual guaranteed renewable hospital coverage? What has been the reaction of policyholders?

D. Are smaller companies experiencing a demand from their agents for both commercial and noncancelable (or guaranteed renewable) lines of disability income policies? What problems are created by having two such lines of policies?

MR. LEROY T. WATKINS: The smaller company is unable to develop a sufficient premium income without getting into the hospital-surgical and medical area of the protection. At Inter-Ocean Insurance Company, approximately 40 per cent of our new issues are on forms other than hospital-medical-surgical, so in order to support an operation you do need the basic hospital protection coverages.

We have had major medical for approximately three years, but we have had very, very limited sale. So far, claims are running approximately 45 per cent of premiums, for which we are quite thankful, because we did attempt to get reinsurance and found the reinsurance company wanted too great a proportion of our gross premiums to give us the protection for the amounts in excess of $2,000. For protection of from $2,000 to $10,000 they wanted 20 per cent of our gross premium, but judging from casual conversations I have had, apparently this is normal. We felt it was too great, so we have retained our own limits on the entire protection up to $10,000.

MR. FRANK W. LACKIE: At Western Life we have developed our individual health insurance portfolio over the past five years, having decided to offer both noncancelable and commercial because there was a demand for them. Although some agents have a preference for one or the other, most agents like the idea of having both, depending on the market they are selling to at that particular time. Currently we are issuing about twice as much noncancelable as commercial, with the total sales greater as a result of having both.

Although we have experienced no problem as yet by having both the noncancelable and commercial plans, we do anticipate that if some time in the future we have to adjust the premiums or modify in some way the commercial business, it may be difficult to explain if the policyholder compares it to the noncancelable business, which would not have any action of this sort. When the time comes for such an adjustment in the future, our explanation would be on the basis of the rate differential between the noncancelable and commercial at the time of issue. Our noncancelable rates run from about 30 to 35 per cent higher than the commercial rates; however, the noncancelable policies do include some benefits which add to the premium differential with the commercial policies, in addition to the renewal provision.

(1) The automatic waiver of premium takes effect after 90 days of continuous total disability rather than 180 days under the commercial. (2) During the elimination period, if the insured is confined in a hospital, benefits are paid under the noncancelable policies only. (3) Any injuries treated by a physician are covered up to one-fourth of the accident monthly indemnity under the noncancelable policies. We estimate that if these three benefits were excluded from the noncancelable policies, the premium would be from 20 to 25 per cent higher than the commercial.

A problem of anti-selection by age is created if the broader age groupings are used for the commercial line while the noncancelable rates vary for each individual age. There is a tendency for those in the upper portion of the age bracket to select the commercial, thus making the average age for each bracket under the commercial higher than anticipated. It is also important to apply the same underwriting rules in regard to physical condition and medical history under both lines, generally speaking, but we have found it helpful in several instances to be able to offer the commercial in certain situations involving occupation or, as in one case, where we had an application from an immigrant who was not certain whether he would be remaining in this country permanently.

As the premium volume for the health insurance increases, there is an improvement in the expense ratio allocated to this block of business. Since sales should increase as a result of offering both lines, it is possible to reach the point at which this business becomes profitable at an earlier date if you have both lines.

MR. GERALD A. LEVY: I have prepared this discussion jointly with Christopher Cox, who is not a member of the Society. Major medical policies with deductibles of less than $500 and with blanket-type benefits sell better than higher deductibles and scheduled benefits. At North American Reassurance Company we, as a reinsurer, are cognizant of the trend toward both higher deductibles and more scheduling of benefits. Modest-sized companies however, which do not have an adequate spread of risk but which to date have had a favorable loss ratio, have a tendency to ignore the trends of the larger companies. We feel that the experience of the giants in major medical, with their much greater exposure, is certainly more credible over a period of time, and the changes which those larger companies have made to combat unfavorable trends should not be completely ignored by the smaller companies, whether those changes be premium increases or policy restrictions. If the market is similar between the small and large company and if the area of costs is similar, it is all the more imperative that the modest-sized company not ignore the current trends.

There is not a great need for major medical reinsurance. The maximum claim liability usually ranges from $5,000 to $10,000. A need may arise if the smaller or medium-sized company expects a high volume of sales and desires surplus relief. Also, a good argument may be advanced in the case of a small company concerned with the experimental nature of the risk and desiring to rely on the knowledge and experience of a reinsurer.

Reinsurance is on a quota share basis, coinsuring the direct writing company's premium rates. The company determines what share of each risk it wishes to retain, say 75 per cent, and the remainder, 25 per cent, is coinsured. From our over-all study, an appropriate level of commissions and allowance is determined to cover approximately the direct writing company's percentage of premium expenses. We do not offer excess reinsurance on major medical policies.

In excess reinsurance a claim amount division point is specified whereby the excess claim cost above this point is paid almost entirely by the reinsurer. This type of reinsurance, especially in major medical, has many problems for the ceding company and reinsurer. Some of these are: It is difficult to determine a premium rate equitable to both the reinsurer and the ceding company. The direct writing company assumes an additional risk, and usually no margin for this is included in their rates. Very little surplus relief occurs under excess reinsurance. If this is of major importance a lower retention and quota share coinsurance may be the best solution.

I should mention that the picture for excess reinsurance is not quite so black as I described; as more experience is published, a more reliable, basis will become available to develop appropriate net premiums. If the market demands, no doubt excess major medical reinsurance will one day be available on a basis equitable to both the direct writing company and the reinsurance company.

MR. WILLIAM TOZER: I would like to raise a question on Part C. Of those companies which issue guaranteed renewable policies, how many have actually filed for a rate increase and how many have not? I think it would be interesting to find out whether there has been much action in filing for rate increases under guaranteed renewable, or is this, at the present time, strictly an academic question?

We at American Republic are basically a hospital-medical company, but I would like to make a comment on Part D in relation to the hospital-medical line. Prior to 1961 we sold strictly a commercial contract. During the years 1961 and 1962 we sold both a guaranteed renewable line and a commercial line. During this two-year period we made every effort to prevent the salesmen from discussing both types of coverage to the same applicant. We found that the salesman would have a tendency to start his presentation discussing guaranteed renewable. The applicant would like the policy but felt that it was a little too expensive. Consequently, the salesmen would then sell a commercial policy with its lower premium. However, when the policy was delivered, the applicant was unhappy because he was not receiving the guarantees offered by the guaranteed renewable policy. We have now discontinued our commercial line completely. There was some complaint from the sales force for a few months, but after we had educated the salesmen about the guaranteed renewable idea, we had no resistance.

MR. GERALD G. TOY: We have a client who, approximately six or eight months ago, decided to change the rates, which were inadequate for their hospital-surgical-medical policies, and at that time decided to apply for an increase in existing policies commensurate with the increase in rates for new policies to be issued. The guarantee was made that no policy would pay less than two year's premiums under the old scale. It was successfully done, and no difficulties were encountered.

MR. T. LOYAL ANDERSON: On this thinking about commercial versus noncancelable guaranteed renewable, I think we should all have in mind that if we offer a policy at a level rate without any anticipated step-up in the contract, at least should we not set up active life reserves, especially with the concept that we are not going to terminate because of the deterioration of health? I do not see much difference between the two types of coverage from the standpoint of morbidity costs. There would probably be a difference in commission, and most likely the commercial type would carry a higher rate.

MR. JAMES W. KEMBLE: Again on this topic of commercial as opposed to guaranteed renewable or noncancelable, I think a prior speaker quoted a difference of about 30–35 per cent in the premium scale between the commercial and the guaranteed renewable, and this causes me to wonder, if I were buying an income disability policy for myself, whether the guaranteed renewable feature is really worth that much difference? Perhaps I would pick a company I felt was pretty reliable and buy the commercial policy on the assumption that they very likely will not increase their premium scale.

MR. DALE L. HAAKENSTAD: I would like to make one comment on Part A in regard to our company. We started selling noncancelable about four years ago, and we anticipated it would be hard to develop a large volume on this one line; this has been true. It is hard to develop enough premium to cover your expenses.

I think there is another factor, too, and that is the role of health insurance as a segment of your business. It has such a small total impact on our company that it tends to be overlooked, whereas if we were developing a larger health insurance premium volume it would enter more definitely into our planning.

AGENCY DEVELOPMENT

A. What changes have been made in new agent compensation plans to stimulate successful agency development programs? What measures of early performance are being used?

B. Is there a trend in smaller companies toward personal producing general agents rather than managers or general agents?

C. Have persistency elements in compensation proven effective? Are these incentives directed at the agent or general agent/manager?

MR. JOHN C. ANGLE: The life industry is challenged to at least hold its position as a medium of savings in an economy which is geared to growth. Essential to this commitment to growth is a capable and aggressive agency force.

We at Woodmen Accident and Life Company have concluded that agency finance plans are essential not only to growth but to the maintenance of current strength in our agency force. We formerly followed the view that the agency manager should share the financing cost of new agents. We found that in new agencies we had to increase the compensation of the manager each time he hired a new financed agent, so the company had to stand all the financing cost for new agencies. The older agency managers were reluctant to hire the better prospective new agents because of the heavy penalty to the managers' current income that resulted.

We now offer two new agent financing plans that are entirely supported by the company. One plan provides a stipulated monthly income of from \$350 to \$500 depending upon the needs and ability of the new agent. The agent also gets up to one-half of any first-year commissions earned in excess of the validation schedule. In the event of failure, all overwriting commissions and deferred first-year writing commissions are retained by the company. Our second plan pays a financed agent a stipulated income of up to \$200 per month plus all first-year commissions earned by him. This plan is designed to provide a new agent with approximately anticipated renewal commissions at the end of the financing period. We have concluded that the subsidy now paid, approximately \$900 over the three-year period for each \$100 of monthly financing income, represents the maximum amount that the company can realistically invest in the financing of a new agent. Improvements to these plans that we have in mind are: (1) Fit the validation schedule more carefully to the production objectives that must be met for successful validation. (2) Provide each financed agent with greater incentive to achieve higher income, particularly during the second and third year of financing.

Financing plans are but one part of the successful agency development program. Other necessary ingredients are a good selection process and a good training program for an ever more complex and competitive business.

The measure of performance that should be applied to all agency development programs is the rate of return on funds committed to the program and the number of years required for these expenditures to be repaid from the earnings on business developed by new agents and agencies. Studies show, as would be expected, a far better rate of return on funds spent in existing agencies than in new ones.

We feel that the primary job of a general agent is to develop, train, and motivate full-time producing agents. Appointment of a full-time producing general agent amounts to little more than a means of providing an outstanding personal producer with an especially attractive compensation plan.

We believe that a persistency element in agency compensation is an effective way of continuing to emphasize the financial results of writing good business. However, compensation based on persistency is not a panacea for high lapse rates but is merely one element in a comprehensive program that begins when we hire a new agent and that depends upon the training he receives and the effectiveness of the supervision he receives from his agency manager and the home office.

MR. GERALD G. TOY: In talking with a number of capable agency people, both clients of Stennes and Associates and others, I found no magic formula for agency development. In fact, there is one thing that is more important to both small and large companies than a formula—that is a capable and effective home-office agency department. Even the best formula will not work with an inactive home-office department, and even a fair one will work if you have a good department.

Here are some general methods that are being tried to provide adequate compensation and some of their basic characteristics:

1. Annualization of premiums and commission regardless of mode of payment. There are pitfalls to this arrangement. For example, some companies have had agents who submit business without any person really being the applicant. They presumably submit a monthly premium to receive annualized commission. One company has built into its financing arrangements a limit on the surplus payment to be incurred on behalf of a new agent. They find a mutually agreeable monthly income for the new agent and annualize all his commission.

They limit his debit balance to one and one-half times his monthly income. They give an incentive to the general agent by allowing him a bonus equal to one month's income to the agent if the agent survives one year and has a credit balance.

2. Extra commission compensation for actual sales, more than is called for under the regular agency contract. These supplemental commissions are paid to both the agent and his general agent and, being a function of regular commissions earned, are based on actual performance. In one rapidly growing company this plan works as follows: (*a*) supplemental commissions go to both the agent and his general agent; (*b*) the supplemental commission runs for twenty months to the agent, grading from 40 per cent of the base commission in the first eight months down to 10 per cent in the last three; (*c*) for the general agent supplemental overwriting runs thirty-two months, grading from 50 per cent in the first eight months down to 10 per cent in the last twelve; and (*d*) this company uses two validation schedules, one a minimum for remaining with the company and the other one that they hope the agent will hit in order to have a good probability of becoming a successful agent.
3. Outright subsidies if the new man meets his validation schedule.

It appears that there is a trend toward the use of personal producing general agents for several reasons. One reason given was that the other way had been tried and found too costly. Other reasons given were: (1) It gives the agent a firm foundation because he learns that company's product and he has a suitable sales record when the time comes to add men. (2) It aids his self-financing and provides collateral for future losses. (3) It cuts agency overhead so they can pay the general agent's scale. (4) General agent's contracts are often given to fire and casualty agencies with the hope that they will sell life insurance to their controlled accounts.

There seem to be mixed feelings on the effectiveness of a persistency element. One company felt that a study of persistency by company indicated that the persistency element had no appreciable effect, so they do not include it directly in the compensation plan. They instead point out to their agents the effect of poor persistency on compensation. Another company thought it would be effective if properly enforced.

MR. BURNESS R. EILER: At the North American Life and Casualty Company we have used a persistency bonus based on the net annualized first-year commissions, which we define as the sum of first-year annualized commissions less twice the net of lapse and reinstatements on policies with under two years' premiums paid.

The bonus is a percentage of the net annualized first-year commission graded by length of service of an underwriter and by total amount of first-year annualized commission earned in a given year. There is a minimum of $1,500 first-year commissions in a calendar year to be eligible for bonus or to count as a full calendar year of qualified service. The statements mailed to the agents show the bonus earned for the period and for the year to date. We feel that the rush of issues and reinstatements at the end of the year is due to the qualification for bonus rather than just the end of another admission period.

MR. J. STANLEY HILL: About ten years ago, Minnesota Mutual Life Insurance Company adopted a persistency plan which we credit with reducing our lapse rate by one-third. We calculate an agent's persistency ratio by dividing paid volume for the last eight quarters into the amount of that business still in force, died, or converted. The ratio obtained can double his renewal commission. The bonus on renewal commissions goes up in brackets of 20 per cent. To get the first 20 per cent he must have an $87\frac{1}{2}$ per cent ratio. To get the last 20 per cent he must have a $97\frac{1}{2}$ per cent ratio. A similar ratio is figured for general agents, and a number of the general agent's compensation elements are significantly affected by his persistency ratio.

MR. DALE L. HAAKENSTAD: We have noticed at Western States Life that those agents who begin on the annualized commission basis tend to remain on that basis. We have a bonus similar to that mentioned by Mr. Eiler which we feel results in measurably improved persistency.

FEDERAL INCOME-TAX AUDITS

A. What changes in company tax returns have auditors required in
   1. Assets?
   2. Handling of due and deferred premiums?
   3. Advance interest on policy loans?
   4. Other areas?

B. What matters remain unsettled in connection with audits pending further regulations or court decisions?

C. Are there any techniques which proved helpful in preparing for and dealing with the auditors?

D. What have companies done after the audits were completed to resolve the questions and problems raised?

This topic, which concluded the program, was discussed by several members, who related actual experiences and problems in connection with federal income-tax audits of company tax returns.