

# TRANSACTIONS

OCTOBER, 1962

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## DIGEST OF DISCUSSION OF SUBJECTS OF SPECIAL INTEREST

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### INDIVIDUAL LIFE INSURANCE

#### *Dividends*

A. "Net cost formulas at present in use for participating insurance should be superseded by a sound *net cost* formula which would include the investment value of the premium dollar and ignore the averaging of dividends."

In view of the above and similar criticisms, are the traditional average net cost and average net payment illustrations still satisfactory? How far should companies go in assuming a rate of interest for projected accumulations?

B. What modifications of regular dividends have been used in such special areas as substandard insurance, guaranteed issue, pension trust, salary allotment, etc.? How far do these appear to have been justified by experience?

MR. WILLIAM A. KELTIE: Criticisms of the net cost formulas include: (a) They ignore interest which premiums would earn if otherwise invested. (b) Average dividends have little meaning with trends toward termination dividends and steep dividend scales. (c) Projected costs are not accurate as dividend scales change continually. (d) Formula costs apply only to rare buyer who survives twenty years and then surrenders. (e) Formulas ignore the decreasing amount at risk.

The formula has merit in being simple and as a sales tool producing lower net costs.

The criticism of the net cost formula would be largely overcome if the annual outlay were accumulated at interest. This would raise the problem of estimating what net interest rate the prospect will earn over the next twenty years.

Dr. Joseph M. Belth, assistant director of the American College of Life Underwriters, has suggested an accurate formula. He points out that each year the policyholder can choose between surrendering the policy to invest in other forms of savings and paying the net premium to receive an increase in the cash value at the end of the year plus one year's insur-

ance protection. His insurance cost for the year is represented by this net outlay plus loss of interest on the net premium and cash value divided by the amount at risk.

I believe the choice between insurance companies and plans of insurance and regarding replacement of existing policies should be based on a method adjusted for the interest element rather than on the traditional net cost formula.

MR. IRWIN T. VANDERHOOF: I believe that the average net payment concept is reasonably useful from the point of view of the buyer and may bear some relation to the relative cost of insurance between different companies. However, overemphasis of this concept has resulted in downgrading the unique value of life insurance as an investment and the unique ability of the life insurance industry to make guarantees. Field pressure has resulted in companies aiming at twenty-year net costs, while companies in concentrating on these costs have allowed the public to fall victims to the delusion that life insurance is not a good investment. In fact, it is an excellent investment for persons in all tax brackets.

A simple method of including interest in net payment illustrations is to obtain a "level dividend" equivalent in value to actual dividends where such value is based on interest at the rate used in dividend accumulations. Probably some companies would change competitive positions slightly using this method.

MR. BERT A. WINTER: I feel some form of "averaging" must be used if a prospective purchaser is to choose intelligently among nonparticipating and low and high premium participating policies. The traditional annual "ledger cost" may, however, be regarded by some as misleading or confusing. This could be avoided by accumulating premiums at interest, although it is not clear that a meaningful standard could be developed. A more fundamental weakness of this would be the implication that interest on the portion of premiums used for current benefits is an element of cost.

A more complicated calculation of cost would be the net outlay the company would charge for renewable term coverage for the amount at risk. This would be quite suitable for simple arithmetic averaging. However, the company may not offer renewable term coverage at the highest attained ages and the lowest amounts for which permanent policy illustrations are now prepared. Such an illustration must be accompanied by a statement regarding the "savings element" of the permanent policy. Although the results would not be favorable in early policy years, results

by the end of twenty years would be quite favorable, particularly when viewed in light of the stability of life insurance company investment.

Traditional net cost illustrations have the advantages of being simple, referring only to the particular policy being illustrated, and being susceptible to comparison with actual experience as it unfolds. In my opinion, these advantages offset the somewhat illusory advantages of the theoretical refinements I mentioned.

In the Prudential, no modifications of dividends are made for various rating classes or modes of premium. Current experience in relation to premiums charged for each dividend cell is used in calculating dividends. The only exception is the dividend treatment of policies issued so as to be included as "pension plan reserves" where dividends reflect the lower federal income tax.

MR. ALBERT H. KRETSCHMER, JR.: Dr. Belth has written an article soon to appear in the *Journal of Insurance* expanding the method Mr. Keltie mentioned. The article deals with policy replacement.

MR. RUSSELL M. COLLINS, JR.: I believe that surrender net cost figures will seldom be realized in the case of an individual or company comparison. The life insurance industry should expend its efforts in demonstrating the tremendous value of continuing policies rather than costs on surrender.

MR. DATON GILBERT: In the Connecticut Mutual, our salary allotment administrative practices are designed to avoid applying dividends against premiums to avoid special treatment when a dividend exceeds a monthly premium.

With substandard insurance, we use substandard functions in converting cash dividends to additions and, of course, in determining surrender values of these additions.

We have recently established a separate class for use with Employee Plans business where modifications in regular dividends have been made. Mortality and interest factors used for dividends of this class are the same as for regular business. Modifications which have been made through the loading factor include:

- a) Recognition of the additional mortality cost in excess of expense savings in the form of a level charge for a given issue age and plan of insurance with due regard to the proportion of business expected to be subject to "simplified acceptance" underwriting.
- b) Recognition of higher administrative costs of this class by a charge of a small amount per thousand plus a small percentage of premium.
- c) Recognition of the estimated cost of the more favorable Change of

Plan provisions in "combination" plan policies in the form of a charge increasing with duration.

- d) Recognition in dividends for the nonterminating form of policy of the extra cost of the adverse selection due to its nonterminating feature.

Since many features of this class are new, we plan to follow carefully the actual experience as it unfolds.

**MR. ROBERT L. WHITNEY:** At the Mutual of New York, we issue policies on a guaranteed issue basis subject to certain controls. We plan to eliminate the second-year dividends for these policies and reduce the third and subsequent dividends by a factor which is constant by duration but varies according to age.

This modification was derived from asset share calculations which recognized the expected higher mortality and lower underwriting expenses of the business. In addition, for qualified pension trusts, dividends are increased by a percentage of the mean reserve.