**TRANSACTIONS OF SOCIETY OF ACTUARIES
1965 VOL. 17 PT. 2 NO. 48**

# DIGEST OF DISCUSSION OF SUBJECTS OF SPECIAL INTEREST

## INDIVIDUAL LIFE INSURANCE

*Leased Life Insurance*

A. What are the advantages and disadvantages to the policyholder of "leased" life insurance, considering: the cost of coverage, control of the policy and deductibility of part or all of the lease charge from the policyholder's taxable income?

B. What peculiar underwriting problems are involved in leased life insurance?

C. What has been the volume of sales?

MR. RICHARD M. STENSON: "Leased" life insurance might be described as an arrangement similar to minimum deposit which is established by a third-party service corporation. A level death benefit is maintained by supplemental term insurance for the cash value, and a level charge is paid by the insured during the entire term of the agreement.

In the case of an existing policy placed under such an arrangement, the first step involves the policyholder's assigning his policy to a service corporation, in return for a payment equal to the current cash value. A lease agreement is entered into with this service corporation. Under the terms of this agreement, which usually runs for twenty years, the policyholder pays a level annual lease charge. The service corporation in turn keeps the policy in force by paying the premiums and is entitled to any dividends and to the cash value.

The service corporation purchases increasing term insurance from an insurance company so that a death benefit of the full-face amount of the policy, rather than the face amount less the cash value, may be paid to the policyholder's beneficiary upon his death during the lease term. In order to make this possible, the policyholder must be insurable at the inception of the agreement.

To procure funds to carry this arrangement, the service corporation borrows on the policies assigned to it, with reassignment of the policies involved.

The leased life insurance arrangement may also be entered into at the time a new policy is sold by agents of an insurance company which has entered into a working arrangement with the service corporation. The corporation requires a high early cash value policy, an override fee or commission, and an agreement to cede a certain amount of reinsurance business to an insurance company with which it is associated.

Since the permanent insurance aspect of the policyowner's coverage is lost during the term of the lease, the most meaningful cost comparison, at least as far as new issues are concerned, is with level premium term insurance for the lease term. In cases which have come to our attention, we have found that level term insurance cost generally compares favorably with the leasing arrangement cost.

At any time during the lease period (or at its end) the policyholder may recover his policy by payment to the service corporation of the then cash value of the policy, or he may simply terminate the lease without recovering the policy. The service corporation may terminate the lease upon default in payment of the lease charge, or, if it terminates, all similarly situated leases under like agreements. The latter condition is a unilateral right not found in life insurance company contracts. If the corporation were to terminate the lease prematurely, the individual desiring continued insurance protection would have to pay in the full cash value or continue the policy subject to a full policy loan, and either situation might impose financial hardship.

Although I understand the leasing arrangement includes safeguards to prevent the inadvertent lapse of the policy, the policyholder is nevertheless not directly involved in the payment of the premiums. If lapse occurs despite these safeguards, the policyholder might be in a difficult situation, especially if he has become uninsurable.

The question of tax-deductibility of all or part of the lease charge is of utmost significance when considering the attractiveness of the arrangement. Since this arrangement involves borrowing by the policyholder against the cash value of the policy, the lease charge includes an element to pay interest on such a loan. Although current tax laws and regulations do not bear directly on this situation, it is possible that Section 264 of the tax law and the supporting regulations adopted November 23, 1964, may have some application in this area. This law and regulation might preclude tax deductions for interest charges under "leased" life insurance as interest paid in connection with a plan of purchase which contemplates systematic borrowing against the policy. Deductions may be allowed under an exception permitting $100 of such deduction or under an exception permitting deduction of interest on indebtedness incurred in connection with trade or business.

"Leased" life insurance is a complex arrangement involving several parties and unusual creations and transfers of rights and privileges, and it would seem that an individual contemplating such an agreement would do well to seek his attorney's advice.

MR. CHARLES T. WHITLEY: Is the form of the increasing term insurance individual insurance or credit life?

MR. STENSON: I believe it is individual insurance.

MR. T. ARNOL CROWTHER repeated the discussion which he had presented at the New York Regional Meeting, reported in *TSA*, XVII, D12.

*Agent Training and Support*

Has greater emphasis on the development of the "higher income market" produced problems of coordination between actuarial and agency departments, with regard to:

A. increased complexity of agent training?
B. the creation of units in the home office agency or actuarial departments to deal particularly with business insurance and estate planning proposals? What techniques are used, such as computer-prepared programming guides or sales illustrations?

MR. HENRY C. UNRUH: At Provident Life and Accident, our average new ordinary policy is approximately $30,000. It appears that we would, therefore, qualify as being heavily involved in the higher income market, where the average policy is large and the persistency better than average.

Our recent agency expansion has been directed toward opening general agencies in new geographic locations instead of recruiting new men into existing agencies. We try to hire experienced general agents who have a proven successful record and who are at home with the sophisticated buyer.

We have established a special section in our agency department to keep our field force informed in advanced underwriting matters. This staff's prime function is to keep abreast of new markets, new products, changes in tax and other laws affecting the sale of life insurance, and to disseminate this information to other departments of the home office as well as the field.

The actuarial department programs the various computer aids to selling. Although we print complete booklets containing ledger sheets and similar information, we also have a personalized proposal service. From a simple card questionnaire we can calculate the amount of insurance required for the prospect to complete his desired insurance program. We offer another widely used computer service where the agent checks a card to indicate the type of illustration he desires and the amount and plan of insurance. Within a short time he has a complete ledger statement for the prospect. Illustrations of net cost, split-dollar insurance, key man coverage, deferred compensation plans, and minimum deposit programs are available.

MR. ELGIN R. BATHO: At the Berkshire Life we have established a service department, specializing in estate analysis and similar programs. We also use an independent computer service for personalized programs analyzing the prospect's needs. On our own computer we provide ledger statements, split-dollar proposals, and minimum deposit proposals within two days after the request is made. This service has been well received.

MR. HUDSON J. STOWE: At Manufacturers Life we use, in our largest branch office, an IBM 832 for preparing ledger-type proposals. This branch is able to complete all requests the same day. We have had difficulty in correlating sales to individual proposals, particularly those prepared for brokers.

*Participating Business Written by Stock Companies*

A. What plans are most suitable for issuance by stock companies on a participating basis? How have sales results compared?

B. With respect to such policies, what actuarial principles are involved in determination of gross premiums, dividends, and the amount of profits to be retained for stockholders?

MR. KENNETH P. HINSDALE: A stock company desiring to issue par business must give careful attention to the plans of insurance to be made available. Each line will tend to become a competitor of the other, and pressure may arise to issue every plan both par and nonpar. The final determination of the par plans should be made only after examining the following factors:

1. Effect of the par plan on sales of comparable nonpar plans.
2. Effect of the par line on the company's field operations.
3. The safety element afforded by the higher par premium (particularly important in plans with a high investment element).
4. The tendency of par insurance to produce a faster rate of increase in both premium income and assets because of the larger gross premium, the deferral of dividends, and the existence of dividend options under which dividends are left with the company.
5. The deficiency reserve problem if a plan is to be issued only on a nonpar basis.
6. The competitive advantages of par insurance arising from the necessity for conservatism in calculation of nonpar premiums and the traditional method of illustrating costs by subtracting the sum of 20 dividends and the 20th year cash value from the total gross premiums.
7. Effect on the company's federal income tax.

An analysis of these factors may indicate that it is desirable to issue the following plans on a par basis:

1. Endowment plans with a large savings element where the corresponding nonpar premium would seem noncompetitive because of the necessity for a conservative interest assumption.
2. Plans to be used in connection with Pension Trust business, especially if issued on a Guaranteed Issue basis, so that dividends may be adjusted to reflect actual experience.
3. Plans issued in connection with pension and other tax-sheltered business in order that dividends may appropriately reflect federal income tax savings.
4. Business insurance sold on a split-dollar or ledger cost basis under which high early cash values and a one-year term insurance dividend option are desirable.

5. Any plan which, if issued nonpar, would require deficiency reserves that create too heavy a drain on surplus (not now a serious problem under the 1958 CSO Table but may become one).

Some light might be shed on the question by noting that stock companies writing participating insurance generally limit their sales of term insurance to a nonpar basis only.

As to Section B, we at the Jefferson Standard feel that the actuarial principles involved in determining gross premiums and dividends are essentially the same as for a similar mutual operation. Par and nonpar lines do compete with each other, and there are advantages in preserving the distinctive features of the separate lines. Consequently, adoption of a moderately high premium, high dividend philosophy may be desirable since a low gross par premium approach would result in products too nearly alike.

Determination of distributable par surplus does, however, present two important additional problems. First, a system must be established which will provide as exact and complete a separation of accounts as possible. Such a separation of accounts involves little new in actuarial theory or practice, since companies are long familiar with the problems and techniques of separating major and minor lines of business. Separation should provide for separation of the surplus accounts as well as the gain and loss exhibits. Second, the amount of profits to be retained for stockholders must be determined. Theories have been advanced for stockholder's charges ranging from zero to 100 per cent of the par profits after provision for policyholder dividends. The actual charge should be determined only after considering the company's charter, management's philosophy regarding the relationship of par policyholders and stockholders, and the various requirements of the regulatory authorities. State laws which place some limitation on the amount of the stockholders charge, such as 10 per cent of par profits or 50¢ per year per thousand of par insurance in force, may override all other considerations.

Although relatively few jurisdictions have laws governing the separation of accounts or stockholder charge limitations, the subject is of considerable interest to the Blanks Committee of the NAIC and the Securities Exchange Commission. The possibility of additional regulations in this area in future years should not be overlooked.

The recent book, *Participating Life Insurance Sold by Stock Companies*, by Dr. Joseph M. Belth of Indiana University, provides much useful information on this subject and is highly recommended for those interested in further study.

MR. J. ROSS GRAY: The Canada Life spent the first 115 years or so of its existence as a stock company writing par as well as nonpar business. Since then, it has been a mutual company writing nonpar business, except in the United States. We have found that much the same considerations apply.

In 1875, long before there was any Canadian law on the subject, our directors apparently felt that there should be a limitation on the amount of surplus which the shareholders could take, if applicants were to be asked to pay the higher premiums required for par policies. In that year 75 per cent of the profits went to the policyholders and 25 per cent to the shareholders.

This was formalized in 1879, prior to the next quinquennial distribution of profits. The company's charter was amended so that the par policyholders would receive not less than 90 per cent of the profits. Note that this was profits from the par and nonpar business combined.

The Dominion of Canada later passed a law requiring separate accounting of par and nonpar business and requiring that par policyholders receive at least 90 per cent of the profits from par policies. It placed no limitation on the profits going to shareholders from nonpar business, other than what might exist in the companies' charters, etc.

This section of the law was later amended, so that the portion of the profits on par business going to par policyholders must be at least

90 per cent where the mean par fund does not exceed $250,000,000;
92½ per cent where it exceeds $250,000,000 but does not exceed $500,000,000;
95 per cent where it exceeds $500,000,000 but does not exceed $1,000,000,000;
97½ per cent where it exceeds $1,000,000,000.

We have found the nonpar basis best for term plans, particularly when running only a few years. The par basis is best for plans with a high investment element, unless the term is quite short, and there also exists the condition that current interest rates on new money exceed those reflected in the dividend scale.

We have thought it essential to have the results on par, and on nonpar, policies reasonably comparable. The Canada Life uses a two-factor dividend scale which seems to lend itself to this purpose, although a three-factor formula might also have worked.

It has seemed desirable to calculate guaranteed values on par policies at a lower interest rate than on nonpar. Apart from that, we follow much the same general pattern of building up to the full net level premium reserve over a period of years.

MR. HARWOOD ROSSER: Gulf is a stock company which started issuing par business just about three years ago.

We have a guaranteed change clause written into our policy form. However, we specified that nonpar policies could only change as of original date to nonpar, and the same for par policies. We felt that trying to figure out the amount of assets transferred between accounts, on original date changes between par and nonpar, was much too complex and ruled it out by policy provision.

We did not attempt to restrict term conversions.

*Multiple Interest Rates*

What are the advantages and disadvantages of the use of more than one interest rate (e.g., 3 per cent for twenty years and 2½ per cent thereafter) for determining reserves and cash values under currently issued policies?

MR. HARWOOD ROSSER: The only paper that I have seen on this is by Charles Connolly in the 1957 *Transactions*. One of his major objects was avoidance of premium deficiency reserves that arose if you retained fairly high cash values but had low gross premiums. With the 1958 CSO Table, that problem has largely disappeared.

However, Gulf Life, in its 1964 rate book, elected to use split interest rates on all permanent, or cash value, nonpar plans. By a split interest rate, I mean something along the lines of using 3½ per cent for the first twenty years, say, and 2¾ per cent thereafter. We made minor modifications in the period. For instance, on limited pay plans, we broke the interest rate at the end of the premium period, and, on retirement income policies, at the point where mortality drops out, if either was less than twenty years. On jumping juvenile, we split the interest rate at age twenty-one.

The chief advantages are two: (1) It gives you a considerably wider choice of cash value scales. You can have a cash value scale which comes pretty close to the 1941 CSO scale. (2) Depending somewhat upon the company situation, there may be a federal income tax advantage. If you are crediting a higher interest rate in the first twenty years, you have a larger offset to your Phase 1 tax. Also your reserves will increase faster and you will get a greater Phase 2 deduction.

This is not without problems. In fact, without a good-sized electronic computer, it would be a very rash actuary who would consider this. This means that none of the printed tables are of much value to you, except for picking up a few odd commutation functions. Mainly, you have to figure out in your own shop most of your premiums, reserves, cash and other nonforfeiture values. Unless you plan to use an NLP basis throughout, you need more than one set of net premiums and reserves. If you propose to have cash values that grade into something higher than minimum reserves before the end of the premium period, you are going to need a reserve basis that will produce reserves between the minimum reserves and NLP reserves. Also, the maximum adjusted premium will be required.

When you start looking for Commissioners Method Reserves, you find that these are not uniquely defined, at least not unless the interest period is uniform for all plans. Such reserves pivot around a Nineteen-Pay-Life premium. This premium will vary slightly according to whether the interest rate changes after ten, fifteen, or twenty years.

There are at least two interpretations here. These might be labeled the "fixed break point" and the "varying break point" systems. These refer to the point at which the interest rate changes for purposes of computing the Nineteen-Pay-Life premium only. Under the "varying break point" interpretation, this would be the same as for the particular plan under consideration. It is simpler to use a "fixed break point."

It is also closer to the spirit of the Guertin legislation. By experimentation, we found that, for limited pay plans for less than twenty years, the "fixed break point" approach gives slightly higher reserves.

With two interest rates, a problem which does not arise immediately, but which will have to be faced ultimately, is the valuation of amounts of extended term insurance. A new variable has been introduced: the point at which the interest rate changes. Using the obvious approach, you would need to store nearly 100,000 different reserve factors.

One possible solution, mentioned in the discussion of Connolly's paper, is the use of the ultimate interest rate for valuing all extended insurance. We are reluctant to consider this.