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CURRENT INDIVIDUAL LIFE INSURANCE TOPICS

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Panelists: RUSSELL R. JENSEN, STEPHEN H. LEWIS.

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2. Section 79 Products

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4. Term Insurance

VARIABLE LIFE INSURANCE

MR. JEROME S. GOLDEN: Before discussing the most current developments in Variable Life Insurance (VLI), I'd like to give a brief background to set those developments in perspective.

After extensive hearings in 1972, the SEC issued Rule 3c-4 in January, 1973, which subjected VLI to the 1933 and 1934 Acts, and exempted VLI from the 1940 Act, subject to the states adopting regulations that would provide for protections substantially equivalent to the relevant protections of the 1940 Act. Under the rule, VLI was limited to products under which the insurance element was predominant.

The NAIC adopted a Model VLI Regulation in December, 1973, that was responsive to Rule 3c-4. During that same year individual companies filed with the SEC Registration Statements (including prospectuses for their VLI products).

Rule 3c-4 started to become undone when the so-called "Mutual Fund Group" contested the Rule late in 1973, and, after a series of interim positions, the SEC withdrew Rule 3c-4 in early 1975. The SEC indicated at that time its intention to propose a general rule exempting VLI from certain sections of the 1940 Act that were inappropriate for a life insurance policy. During the period 1973 to 1975, no companies had their Registration Statements declared effective by the SEC, and, thus, no companies were marketing VLI in the general market. One company had been marketing a VLI product in the tax-qualified corporate market, which product was generally exempt from the Federal securities laws. The variable life products that had been developed for the general market to this point, in terms of commission patterns and cash value structure, generally followed the patterns of comparable fixed benefit policies.

When the SEC withdrew Rule 3c-4, our company decided to restructure its policy and filed an Application for Exemption under the 1940 Act tailored to the revised policy. The necessary exemptions were granted in October, 1975, the Registration Statements were declared effective in December, 1975, and our company began marketing VLI in January, 1976.

Rule 6e-2

The SEC, in December, 1975, published a proposed Rule 6e-2, which outlined the exemptions from the 1940 Act that were available for VLI. The proposed rule defines VLI as a policy which must:

(a) be issued by a life insurer through a separate account;
(b) provide death benefits and cash values that vary to reflect investment experience;
(c) provide a minimum death benefit guarantee; and
(d) have the mortality and expense risk borne by the life insurer.

The proposed rule does not require (i) coverage for the whole of life and (ii) the death benefit to be a minimum multiple of the premium, as in the original Rule 3c-4. Thus, limited payment plans with short premium periods and endowments fall within this general rule. (The NAIC Model VLI Regulation, however, currently precludes such products in the general market.)

The basic exemptions proposed in Rule 6e-2 were similar to those granted our company in the Application for Exemptions we filed. Set forth below is a summary of the major proposed exemptions:

1. Policyholder Democracy - Changes in investment policy of the investment advisor may be disapproved by insurance regulators or the life insurer, subject to certain conditions. The purpose of this exemption is to prevent such a change from having an adverse effect on the general surplus of the life insurer by, say, increasing the costs under its minimum death benefit guarantee because of an overly-speculative investment policy.
2. Voting Rights - Under the proposed rule, votes will be expressed in terms of the variable cash value.
3. General Exemption on Redemption and Pricing - This exemption recognizes that VLI is life insurance and will follow long-established administrative procedures and requirements of state insurance regulation. Transactions covered include: (i) processing of surrenders, options on lapse, and reinstatements, (ii) assigning register dates or reporting initial premiums, and (iii) transferring net premiums and reserves into and out of the separate account.
4. Sales Load - The definition of sales load in Rule 6e-2 follows the approach used in our company's Application for Exemptions. Sales load under this definition is simply the balancing item in the following equation: Excess of the gross premium payable over the sum of (a) the cost of insurance based on the 1958 CSO Mortality Table, (b) the increase in cash value not attributable to investment earnings, (c) a deduction for administrative expenses, (d) a deduction for state premium taxes, (e) a deduction for the risk charge for the minimum death benefit guarantee, (f) premiums for incidental insurance benefits and substandard risks, and (g) a deduction for dividends under participating VLI. The proposed rule listed two alternatives the SEC was considering for the dividend deduction: (a) a deduction in each year equal to the level annual equivalent dividend, or (b) a deduction in each year for the dividend payable under the current dividend scale. Under the proposed rule the sales load must average 9% over 20 years or the life expectancy based on the 1958 CSO Mortality Table, whichever is shorter.
5. Refund under Section 27(d) - This section of the 1940 Act provides for refunds, during the first eighteen months, of excess sales load over 15% on early terminations under front-end load contracts. The proposed

rule would lengthen the refund period to thirty months, but would increase the percentage loading that could be retained by the insurer in the early policy months. Our company did not follow the 27(d) approach, but rather used 27(h), the so-called spread load provision, which provides for sales load of 20% in the first year and average of 16% over the first four policy years, with no requirement of a refund.

Not surprisingly, in a proposal which tried to fit a life insurance product under the 1940 Act, there were extensive comments submitted by the industry, although none were submitted by the Mutual Fund Group. Two areas in which there were extensive comments by the ALIA were sales load and Section 27(d):

1. Sales Load - The industry proposed a clarifying definition of sales load, and a lengthening of the period at the younger ages over which the sales load was to average 9%. In addition, the ALIA suggested that both alternatives for determing the deduction for dividends be included in the final rule.
2. Section 27(d) - The ALIA suggested two alternative schedules: a two year and a four year schedule. Under the four year or forty-eight month schedule, the sales load that could be retained by the insurer grades from 37½% during the first year to 15% at the end of the period.

With these changes in the proposed rule, I believe that additional companies will be able to design VLI policies that can pay a reasonably attractive first year agent's commission, as well as being profitable to the company.

In order to comply with the sales load limitations of the 1940 Act as applied to VLI, which in effect defines cash value on a retrospective basis similar to that being discussed currently for deferred annuities, participating and non-participating policies may follow different approaches. I expect that an insurer developing a participating VLI policy will set premiums, dividends and cash values according to its usual methods and then test for compliance with the 1940 Act limitations.

On the other hand, the pricing of non-par VLI will probably start with the maximum deductions permitted under the proposed rule, with the premium and cash value structure determined to satisfy applicable state insurance laws and regulation. Tests for profitability will then be made to determine what commission schedule is affordable.

Status of State Regulation

On the state regulatory side, the industry will be presenting suggested changes to the NAIC Model VLI Regulation at the NAIC's meeting next week. These changes involve sections of the NAIC Model that were included to be responsive to the original Rule 3c-4. In addition, there will be a hearing on a proposed New York VLI Regulation on June 15, 1976. The New York version is basically a streamlined version of the NAIC Model, reflecting the provisions of Section 227 of the New York Insurance Law and the withdrawal of SEC Rule 3c-4.

Our reading of the state regulatory and legislative status is as follows:

1. Eleven states require specific legislation.
2. Two states require regulation by statute.
3. Fourteen states have approved our forms.
4. Five states where our company is not licensed and where we have no reading.

5. Nineteen states which are reviewing our forms and/or considering regulation.

MR. STEPHEN H. LEWIS: How quickly are the rest of us going to be designing variable life policies?

MR. GOLDEN: Most companies are going to wait until Rule 6e-2 is finally adopted, because it does provide some leeway in terms of sales load. The net effect is to permit a lower first year cash value and possibly a higher first year commission. Also, companies may want to wait until we're in more states and have meaningful sales results. My guess is that EVLICO will be the only company selling VLI in the general market for the next year.

MR. BERNARD GOEBEL: You mentioned a formula for calculating sales load that involved deductions for administrative expense. Is there any indication of maximums that would be allowed?

MR. GOLDEN: The SEC expects the administrative expense to be based on actual expenses projected for inflation. The industry asked, in defining sales load, for an additional deduction for amounts that are not necessarily administrative, but are not properly chargeable to sales or promotional activities. Hopefully, a deduction for expense risk would be permitted.

MR. JAMES J. MURPHY: Is there any progress on the Federal income tax treatment for the company?

MR. GOLDEN: The IRS and Treasury would like to handle the policyholder question and the company question at the same time. We have attempted to separate the issues and have a policyholder asking for a ruling on the taxation at the policyholder level. We think the company question will require legislation, so we don't see an answer to that for three or four years. We have reserved the right, in the policy, to make a tax charge -- although we're currently not making a charge.

SECTION 79

MR. LEWIS: In preparing for this segment on Section 79 products, I have chosen to limit my remarks to selected marketing, product design and pricing considerations. Section 79 regulatory status was discussed more directly at the Houston meeting.

Let me begin by presenting some background information.

"Section 79 Product" is the name given to an individual permanent life insurance policy which has been designed to meet the requirements of group-term life insurance as defined by Section 79 of the Internal Revenue Code. By specially constructing policies so as to separate the term and permanent components, it is possible to qualify a portion of the premium for favorable tax treatment.

Section 79 defines an employee's income tax treatment as a participant in his employer's plan of group-term life insurance. If an employer's plan meets certain requirements specified in Section 79 and its Regulations, then the employee will receive favorable income tax treatment on employer-paid premiums. Generally, the value of the first $50,000 of employer-provided term insurance is received tax-free by the employee; the value of amounts in excess of $50,000 is taxable. The value of this excess coverage is determined by the Uniform Premium Table or Table I rates set forth in the Regulations.

The employer's group-term life insurance plan may be funded by a master group policy or individual policies or a combination of both. Generally, these policies must provide term life insurance benefits only. However, the term component of a permanent policy, what we now call a Section 79 policy, can qualify, provided the policy specifies the portion of the total premium which is properly allocated to the term life insurance. Only this portion of the premium qualifies for Section 79 tax treatment. The permanent portion must be paid by the employee or, if paid by the employer, is fully taxable to the employee.

Market

Agent interest in Section 79 products is running high. Companies are seemingly rushing to introduce products which capitalize on this interest. Sales are strong and the quality of business being written is generally good. Unfortunately, part of this success is explained by circumstances which run counter to the social and economic purpose underlying Section 79. These circumstances include tax advantages not contemplated in the original legislation and the facility to discriminate in favor of selected employees. As a result, the uncomfortable position we find ourselves in today is that the very circumstances which support the Section 79 market also threaten it.

As it has developed, the primary market for Section 79 products is not comprised of employer-employee groups, as such. Instead, it is comprised of selected individuals within these groups, in particular, owner-employees and other favored employees. The appeal Section 79 products hold for these individuals is that they provide a favorable tax basis for increasing compensation -- this, of course, assuming a need for permanent insurance exists.

This favorable tax basis can be considered in three parts. The first part, and the only part contemplated in the original legislation, is the tax-free feature associated with the first $50,000 of term coverage. The second part relates to the Table I rates applicable to term coverage in excess of $50,000. We might expect that Table I would set a value closely approximating the actual cost of coverage and eliminate any tax incentive for providing coverage in excess of $50,000. In fact, however, Table I rates are considerably less than corresponding term premium rates. Consequently, tax advantages continue for amounts in excess of $50,000. This tax feature has become critical to the Section 79 marketplace because many prospects already have $50,000 or more of group term insurance.

The third component relates to the allocation of premium between the term and permanent coverages. Since the employee pays tax on the full permanent premium and since any tax he pays for the term coverage is independent of the term premium, from his standpoint it is desirable to have as much of the total premium allocated to term as possible. If the term premium is covering part of the permanent insurance cost, then, in effect, part of the permanent premium is receiving Section 79 tax treatment and after-tax cost is reduced accordingly. This favorable treatment, whether real or only an illusion, is important. Without it, there is no tax incentive for providing permanent insurance. Whether Section 79 products do, in fact, manage to hide a portion of the permanent cost in the term premium is debatable. What is not debatable is that, in the past year or two, the IRS has been approving very favorable premium allocations. These allocations have unquestionably given a boost to the market.

With respect to antidiscrimination requirements, the Regulations make a sharp distinction between groups with ten or more lives and groups with nine or fewer lives. For groups of ten or more lives, an employer is not required to make permanent insurance, nor, in fact, even term insurance, available to all employees as long as he makes it available to all employees within the specific class to which it is made available. At the same time, the regulations permit considerable latitude in defining classes and establish no limits regarding the amount of coverage to be provided in each class. As a result, it is possible to provide permanent insurance on a discriminatory basis.

This ability to discriminate is an important factor in the Section 79 market. In making the Section 79 sale, the prospect must first be persuaded to increase coverage provided under his corporation's plan. This would typically be difficult if coverage had to be increased for all employees. Second, he must be induced to fund additional coverage with Section 79 products. Even if the employee pays the permanent premium, the remaining term component is still initially more expensive than yearly renewable term. Consequently, persuading a prospect to install Section 79 products would be difficult if they had to be offered to all employees. This was demonstrated when a 1970 Revenue Ruling (70-162) held that, if permanent insurance was offered to any employee, it had to be offered to all employees. Until this Ruling was subsequently revoked, the Section 79 market was effectively shut off.

The situation with respect to discrimination is very different for the under-10-life market. Sales success in this market, in part, reflects the willingness of some companies, agents, and employers to subvert the intent, if not the letter, of the Regulations. For groups of nine or fewer lives, the Regulations do not explicitly permit permanent insurance to be made available only to selected classes. In some instances, this absence of clear authority is being ignored. The Regulations also require that the amount of protection must be computed either by a uniform percentage of salary or on the basis of coverage brackets, under which no bracket exceeds two and one-half times the next lower bracket and the lowest bracket is at least ten percent of the highest bracket. This requirement is often subverted by establishing "phantom" brackets, that is, brackets containing no employees.

These practices are indicative of the general thrust of the Section 79 market; that is, the marketing of Section 79 products, in part anyway, as vehicles for sheltering income of selected key employees. Used in this way, these products are hardly serving the social and economic purpose underlying Section 79, which is to encourage employers to provide reasonable amounts of term protection to all employees. For this reason, it is probably safe to assume that the IRS and Treasury Department are concerned by the developing nature of the Section 79 market and there is no guarantee they won't take action to change the situation.

Revenue Ruling 75-528 provides an indication of what might be expected in this regard. The Regulations have always prohibited the use of medical evidence in determining either eligibility for coverage or the amount of coverage in groups of under 10 lives. Ostensibly, this is an antidiscrimination requirement. Use of medical evidence to rate individual risks within the group, however, is not expressly prohibited and many companies had adopted this practice. In 1974, Connecticut General requested a private letter ruling on this practice. Revenue Ruling 75-528 resulted. In it, the IRS prohibits the use of medical evidence for any purpose. What is alarming about this Ruling is that it can be viewed not as an attempt to better define the limits of discrimination, but as an opportunity seized by the IRS to attack the ability of insurers to operate in the under-10-life market. If this is the Ruling's underlying intent and if this is indicative of the way the IRS will move when given the opportunity, then it may be only a matter of time until other segments or aspects of the market are attacked.

Product Design (Premium Allocation)

Moving to product design considerations, we find another situation which is somewhat disturbing. In order to qualify for the favorable tax treatment available under Section 79, permanent policies must "properly" divide or allocate the total death benefit and the total premium between the term and permanent components. In other words, the premium allocation must meet with IRS approval. The IRS, however, has so far not seen fit to publish explicit rules for making this allocation. As a result, we have no assurance that criteria used by the IRS today will continue to apply in the future.

The allocation can be accomplished in one of two ways. The term and permanent components can be included in separate contracts or an allocation rider can divide the term and permanent components contained within one contract. Regardless of how accomplished, the most important aspect of product design is premium allocation. Not only does qualification depend on it, but the competitiveness of a Section 79 product is very sensitive to premium allocation. The after-tax cost of two otherwise identical products can differ dramatically, depending on their respective allocations.

The IRS, of course, has an interest in premium allocation. Its concern is to limit favorable tax treatment under Section 79 to that which is truly term insurance premium, or, conversely, to prevent any part of the permanent premium from qualifying for favorable tax treatment. Unfortunately, the Regulations are vague in this regard, referring only to "the amount properly allocable to the group-term life insurance". A 1971 Revenue Ruling (71-360) is more specific. According to this Ruling, a premium allocation is acceptable only if the term premium rate, per thousand:

(a) increases each year with attained age;
(b) does not vary with the age at issue or the duration of a companion permanent policy; and
(c) is determined by realistic mortality, interest and other assumptions, including no more than a reasonable share of premium loading expenses.

While the Ruling does set forth certain requirements and does provide general guidelines for premium allocation, it does not tell us how to go about allocating premium. For this reason, most companies choose to request an IRS private letter ruling on their premium allocations. Until recently, companies were largely on their own in developing allocations. Obtaining IRS approval was a hit-and-miss procedure. This situation, in part, accounts for the varied and sometimes unusual product designs we have seen in the past.

Recently, the situation has changed. IRS actuaries have developed explicit criteria for use in reviewing private letter ruling requests. Though not officially promulgated, this criteria has become common knowledge. It is expressed as a formula which defines the minimum permanent premium for each policy year in terms of the permanent death benefit, cash values and dividends, if any. Mortality and interest functions used in the formula are based on eighty-five percent of 58 CSO and six percent, respectively. These rates are presumed to reflect realistic experience. Reportedly, the IRS will listen to any company wishing to argue that some other basis better reflects its current experience.

Though permanent death benefits must be defined in the policy, the IRS apparently imposes no restrictions on how they are defined. Paid-up values, cash values, and arbitrarily assigned uniformly increasing values are all apparently acceptable. In this case, the permanent benefit is seen as prefunding future death cost only and providing no current death benefit.

Knowledge of the IRS allocation formula has affected the shape of Section 79 products. New products appear to be far more competitive than the older varieties they are replacing. And because the formula is easily applied to standard contract forms, such as whole life, most new products take these more traditional forms instead of the unusual designs prevalent in the market earlier.

While the allocation formula in some respects makes our job easier, it nevertheless is causing concern. Foremost among these concerns is that it does not conform to the requirements set forth in Revenue Ruling 71-360. In particular, it produces implicit term rates which do not necessarily increase each year and which depend not only on attained age, but also on issue age. Further, it does not explicitly recognize any loading for expenses in the permanent premium. Beyond these direct contradictions of Revenue Ruling 71-360, the formula leaves at least one important matter unresolved, namely, the proper allocation of substandard extra premium. Compounding these concerns is the fact that it is an unpublished formula and could easily be changed overnight. This could affect the tax status of inforce contracts as well as require the development of new products.

Pricing

There are relatively few special considerations for the more readily measured components of pricing. Unfortunately, the one component which we can't measure overshadows all else. This is the business risk of being in the market. A change in the Regulations which adversely affects the tax status of inforce business would almost certainly result in large scale terminations or the need for a massive conversion effort. In either case, direct losses would be great.

In the over-10-life market, it is typical for a company's regular underwriting rules and requirements to apply. Consequently, a company's standard select and ultimate mortality assumptions should be appropriate. Some companies are developing special products for sale in the under-10-life market. These products will be underwritten using only a medical questionnaire completed by the employee. Medical exams, APS's and MIB's will not be used. These companies are using mortality assumptions which are approximately fifty percent greater than their standard select and ultimate table.

Developmental costs for Section 79 products are high and it may be appropriate to adjust expense assumptions accordingly. The market requires elaborate sales materials and agent technical guides. The typical computer administrative system requires costly changes to be able to accommodate the intricate premium split of Section 79 products. Multiple employer trusts, if used, require special home office administration capabilities. And obtaining the almost mandatory private letter ruling is expensive. All of these are in addition to the usual product development costs.

It is doubtful that any adjustment to regular persistency assumptions is required. In most instances, all or a large share of the premium is being paid by the employer. Sales are weighted toward owner-employees and key-men, among whom turnover should be relatively modest. Further, sale of the product is typically premised on a permanent need for insurance, such as estate protection, and, for many, the employer will continue paying part of the premium beyond retirement. Consequently, there should not be an inordinate lapse problem at retirement ages.

Of course, all bets on persistency are off if there is a change in the Regulations affecting tax status. Some of the factors which operate to increase the possibility for such a change have been discussed. Others include the increasing use of multiple employer trusts to escape the Regulations' limits with respect to state group max laws, and attempts to free the employee from tax on the permanent portion by assigning it to the corporation. So far, the IRS has not had a chance to rule on either of these. If and when it does, it could use the opportunity to further limit the market. It's also possible that the Treasury Department will amend the regulations to reduce the $50,000 exemption, or apply upper limits on the amounts which can be insured under Section 79, or even possibly change Table I rates.

In closing, it is appropriate to point out that changes affecting tax status have occurred in the past, once as a result of Revenue Ruling 70-162, subsequently overturned, which held that permanent insurance had to be offered to all employees, and once as a result of Revenue Ruling 70-360, which prescribed the premium allocation guidelines discussed earlier. In both instances, the lapse problem was severe. The chances for a similar occurrence happening in the future is a risk each company will have to evaluate for itself.

MR. RUSSELL R. JENSEN: This benefit is usually funded with an individual whole life policy. You said that a group permanent contract might be used in this type of market. Is it being used?

MR. LEWIS: I don't think the incentive is there for group permanent. The incentive in a personal insurance sale to an executive or highly compensated individual is the tax advantage.

MR. WILLIAM T. TOZER: You mentioned that the IRS was accepting a zero death benefit on the permanent side. Has any company gotten a private letter ruling?

MR. LEWIS: Yes, I have read the application for one and I've discussed the matter with the IRS actuary.

MR. TOZER: Are you planning on using a zero death benefit in your product?

MR. LEWIS: No, we're introducing our third Section 79 product this month and in it we're using the cash value.

MR. WILFRED A. KRAEGEL: Could you give us more information about the different techniques used for allocating between permanent and term. You mentioned using the cash value, but there seems to be disadvantages relative to the Internal Revenue Code.

MR. LEWIS: The permanent portion is supposed to have some kind of an element of risk and use of the cash value has an element of risk. The problem is that, if there is no element of risk in the permanent death benefit, when the employee takes over the total policy, he may be taxed on the permanent cash value as if it were an annuity. As far as the definition of death benefit, I know of none aside from the point that was just mentioned. There is no reason why the permanent death benefit should be designed for any other purpose than to minimize the permanent premium. The formula the IRS is using includes permanent death benefit to the extent that it's larger rather than smaller than the allocation of the permanent premium increases. The zero death benefit holds some appeal from the standpoint of the design of the employer's plan or group-term life insurance. An employee who elects permanent insurance is not penalized, since his employer is not reducing the amount of term coverage provided. With a $50,000 Section 79 product under which the permanent death benefit is zero, the employer is picking up $50,000 of term, whereas if a cash value were the permanent death benefit, the employee, by electing permanent insurance, is relieving his employer of the expense of providing the term cost for that amount of cash value.

MR. RICHARD W. KLING: I'd like to make a comment on what might be more favorable as a death benefit. In looking at the paid-up value or the cash value, there's a death benefit, your market is primarily superimposed coverage (so that the $50,000 level is not a consideration), and the term is taxed at the uniform premium table rates. It's my understanding that certain select and ultimate mortality tables are acceptable to the IRS. It's possible that the costs are slightly less than uniform premium table rates such that certain allocations to the permanent side may produce a more favorable overall cost to the individual.

MR. GOLDEN: How would a policy where the death benefits are not defined at issue, let's say variable life or cost-of-living policies, be handled?

MR. LEWIS: The IRS surprised me in the way they attacked the allocation formula. They had a choice of either setting a minimum for the term premium or setting a maximum for the permanent premium. They chose to put a minimum on the permanent premium and, as a result, made it difficult to anticipate a policy which does not have everything defined being qualified or approved by the IRS. Even participating policies are approved with respect to the dividend scale filed with the policy. With each change to that dividend scale, the allocation has to be refiled for approval.

MR. LAWRENCE M. AGIN: Do you require individual evidence of insurability?

MR. LEWIS: Yes, we do. The Regulations have no restrictions regarding use of medical evidence, to determine eligibility for coverage, for groups covering ten or more lives. For groups under ten lives, they imposed restrictions on underwriting, supposedly to prevent discrimination or individual selection. In fact, it's operating to prevent a large segment of employees from getting coverage on any basis. Keep in mind that these regulations apply not only to Section 79 products but also to term insurance generally.

To the extent that coverage can be obtained, it is at a higher cost than would otherwise be necessary. Individual underwriting allows for providing insurance at a lower cost.

MR. LEW H. NATHAN*: The typical one-contract approach to Section 79 uses either a whole life policy, a limited-pay permanent insurance policy, or an endowment policy. The premium allocation currently being approved by the IRS is such that the permanent premium tends to decrease over the duration of the contract. Along with the choice of a permanent death benefit that increases by duration, this creates a favorable tax outlook as the duration of the contract increases. This should improve persistency in the Section 79 marketplace, provided the IRS continues to approve the current premium allocation formula.

POLICY LOAN INTEREST RATE

MR. JENSEN: Around 1900, most life insurance contracts had a loan provision in them, and specified an interest rate. There were even some laws on that point. Up until around 1939, the prevailing rate in contracts being issued was 6%, and most companies charged that rate.

Around the middle of the 1930's, this rate was higher than the prevailing market rate, and suggestions were made that the rate ought to be reduced. This was urged by the New York Insurance Department, with a suggestion that there be a flexible rate in the policy. Companies did not follow this lead, and New York adopted a flat 5% maximum law. In 1939, companies began to issue contracts fairly generally with a 5% loan rate.

By the late 1960's, prevailing interest rates in the marketplace were higher than 5%, and it looked like they might go even higher. The regulatory situation then was as follows:

1. In New York and Massachusetts, the maximum interest rate for loans against life insurance was 5%.
2. In seventeen states, a loan provision was required and the maximum rate was 6%.
3. In twenty-one states, a loan provision was required and no maximum was stated -- other than the usury rate.
4. In ten states, there was no statute whatever governing the availability or interest on life insurance loans.

In 1969, Massachusetts passed legislation to increase the rate to 6%, and companies began to change over to that rate.

But 6% did not seem to be high enough in terms of the rates then prevailing and likely to prevail in the future. An industry task force was formed to report to the NAIC on policy loan interest rates, and this report was made in December, 1972. In summary, the model bill recommended:

> A company could issue policies under which the interest rate on policy loans could be changed from time to time. Such changes in interest rates would apply to all loans under these new policies, but would be subject to several restrictions:
> 1. The rate could never exceed some stated maximum.
> 2. Increases could not be made more often than once per year,

*Mr. Nathan, not a member of the Society, is an Actuarial Mathematician at CNA.

but there would be no limit on the frequency of decreases.
3. No increase could exceed 1%, but this restriction would not apply to decreases.
4. The company would not be required to give notice of decreases.

The bill would permit a company to continue issuing policies with a fixed rate of interest for policy loans. The maximum rate for those policies would be the legal stated maximum. This provision would be the same as the present law, except that the common maximum is now 8%.

Following this, there was legislative activity in a number of states. Let me sum up by saying that, by my reckoning, there are now thirty-four jurisdictions which permit an interest rate of as high as 8%, though the detail of the laws in those states varies. My company is issuing an 8% maximum contract in thirty-one of those jurisdictions today, and is discussing the subject with three other states.

Reason

Why would a life insurance company want to charge a policyowner more for the use of his own money?

The question is still asked in the marketplace. The answer comes through most simply when thinking in terms of a participating policy. Suppose a company earns 5.25% after taxes on its portfolio. It has a policy with a 5% loan provision, and after taxes and expenses on that loan it has earned 4.25%. If all the loan values in the policy are borrowed, the dividend is crediting 1% more interest than has been earned on the policy.

So what we are really concerned with is a matter of fair pricing. One way to do it would be to reduce the dividends for those who have borrowed, to the extent they have borrowed. For various reasons, most of them legal, this cannot be done so the next best thing to do is to charge a fair market rate of interest. With an 8% rate for life insurance loans, the company can come reasonably close to earning as much interest on those loans as it can on investments. The borrower pays something close to the prevailing market interest rate, and the dividends for all policyowners are reasonably well insulated from the depressing effect of loans made at artificially low rates.

Can you think of any other reasons for using a higher rate for life insurance loans? I can, and I will mention two.

My company noticed that our life insurance loans as a proportion of invested reserves was growing a good deal more rapidly and to significantly higher levels than many other companies. This has to do with differing propensities to borrow in the major market segments being reached. The drag from life insurance loans on our portfolio rate for dividends tended to make us less competitive. Moving to a more fair price structure between those who borrow and those who don't counteracts the competitive deterioration. I will rest the case for the higher interest rate on the fair price structure theme, but it is unrealistic to ignore the competitive force -- and there are even some left who think that competition is a good thing.

Another reason for a higher rate on life insurance loans is because of the adverse financial effect during times of a credit crunch, which we now seem to get every few years. With artificially low loan rates, life insurance companies tend to be the lender of first resort. So, an insurance company's net cash flow diminishes substantially during a time of credit crunch and less money is available to put out at the favorable rates. And when interest rates go down again, back comes the money by repayment of life insurance loans. There is nothing wrong with that as far as the borrower is concerned, and the borrower has a contractual right to it. But why create such a plum of a contractual right? Again, the advantage is to the borrower, and the disadvantage to the non-borrower. Is this the way to run the insurance business, which has for so long taken such great pains and great pride in its fair price structure?

Status of State Laws

In my reckoning, there are thirty-four jurisdictions in which an 8% contract can be issued, in some form or other, and we are issuing an 8% contract in thirty-one of them. We have five different forms of contract language. If we had it all to do over again, knowing what we now know, we think we could tidy this up to two forms. One of them would read this way:

> Interest is payable at the rate of 8% compounded annually, or at any lower rate established by the company for any period during which the loan is outstanding.

This is the exact wording we had in our contracts before we went to 8%, except we said 6%. We believe such a contract could be approved in about twenty states.

In most other states, we would have a longer clause which reflects in some way the provisions of the model bill. And in two states, we have not been able to get a flexible rate approved at all -- the contract simply says that the interest rate is 8%, period.

We think that states now changing their legislation will divide about 50-50 on a simple clause versus the longer clause more in keeping with the model bill. To balance the views of those who think the longer clause is better for the buyer, there are views that it's too complicated.

What is the general prospect of future legislative action in the remaining seventeen states? I will hazard a guess that maybe for just one or two there will be legislative action this year, and there will be legislative action next year for several more. I will further go out on a limb by hazarding the guess that, by 1980, all or nearly all will have changed their law. I make this forecast partly on the basis of increasing interest in the subject by the industry in general, and also very much on what I would conjecture would be the economic climate of the future. I think interest rates will be high for quite a while to come, and I think more and more people will see this too as the years go by. Sheer realism will then lead to legislative change.

Trends in Company Actions

To what extent are companies moving to some kind of an 8% contract? Of the twenty largest mutual companies, I know of six that are now issuing 8% contracts in some jurisdictions. I am not sure this number is complete. At least one large stock company is now issuing contracts with an 8% clause of some kind, but again I am not sure this is a complete count.

Pricing

This is one of the most interesting subjects of all. The basic rationale for increasing the interest rate on life insurance loans is to return to a more fair price structure between those who borrow and those who don't. Raising the interest rate is half of the picture, what about the other half?

It's easiest to see in participating insurance. If you were to visit a number of state insurance departments and scrutinized the rate books of your competitors which are on file, you would see that there are differences in dividend illustrations for those companies as between a 6% state and an 8% state. Now, if you were to employ your rudimentary actuarial knowledge and assume that rudimentary formulas were used for dividend calculations, you would probably be able to find that the differences in the illustrated dividends could be explained on the basis that everything else in the dividend formula was the same but that the interest factor used in determining the dividend for a policy in an 8% state was in the range of one-quarter to one-half percent higher than that used for a policy in a 6% state.

For most companies the interest factor for dividends reflects the entire company investment portfolio, and is therefore a blend of the result on the life insurance loans and on other invested assets. With the investment return given for the "other invested assets," then the parameters for determining the interest rate are: (a) How much is borrowed; (b) at what rate? If the life insurance loan interest rate is 6% rather than 5%, the dividend interest factor is going to be higher; if it is 8% rather than 6%, again, it will be higher.

So far, so easy. Now we come to the question: How much is borrowed? I know what one company does, both in allocating and illustrating dividends. It uses an across-the-board proportion borrowed.

The business, however, could be broken down into smaller segments. For example, there is the very old business -- say pre-1940. This is business of a certain era, and the observed facts are that it tends to be relatively low in loans. Then there is the business of the last fifteen years or so, the business of another era. This tends to be the most heavily borrowed, except not so much in the very early years of the contract.

Another interesting point is that the proportion of total cash values borrowed is a dynamic figure. For many companies, it is moving fairly rapidly, namely increasing. So, it is possible to make refinements by groupings in the proportion borrowed, and it is demonstrable that the proportion borrowed is changing. Which leads me to suggest that we are at the beginning of a refinement in dividend allocation. This aspect of dividend formulas is under change and will be something different five years from now than it is today.

Sales

There has, of course, been some concern that the introduction of an 8% rate for life insurance loans would impair sales.

My company introduced an 8% contract in twenty-six states in September, 1975. This, of course, was announced in advance, and there was a heavy surge in business in those states prior to the introduction of 8%. For the rest of 1975, the increase in new business in those states was less than the increase in business in the remaining 6% states. In the first three months of 1976, business in the 8% states was up 11% over a year ago, and business in the 6% states was up 13% over a year ago.

Offer to Existing Contracts

There is an old saying that what is sauce for the goose is sauce for the gander. If an 8% contract represents a return to a fair price structure for new business, what would it represent for business already in existence? What happens when present policyowners, who are not in the habit of borrowing regularly, hear about the new contract and think it would be good for them too? Do you tell them to lapse their present policy and buy a new one, thereby reincurring acquisition costs and possibly undergoing a taxable event on the surrender of the old policy? We have long sought to make new provisions in policies available to present policyowners wherever practical, so we had to address this question.

We concluded that what was sauce for the goose was indeed sauce for the gander. We didn't like the prospect of replacement. We didn't like the prospect of agreeing to change only those contracts where policyowners initiated an inquiry with us, greasing the squeaky wheel, so to speak. We wondered if it was practical to make an offer to existing policyowners.

We drafted an amendment form for present contracts and filed it in thirty-one states. This amendment form has been approved in twenty-five of those states.

This amendment form is packaged with a letter to policyowners, which provides a general explanation. It is low-key; we are not trying to sell anyone. We state what the present loan balance is, the present loan rate, and the terms of the 8% rate. We show what the present dividend is, and we show what it would be if this contract had been an 8% contract.

We have mailed this material on an experimental sampling basis in four cities. We provided an in-WATS facility, in case they wanted to raise a question. Of about 5,000 in the sample, a little under 30% requested the amendment for their policies.

We made a follow-up survey of about 1,000 policyowners to see how they reacted. This survey was conducted by an outside firm, and the results were encouraging as to satisfaction and understanding of the offer. We are now moving to a statewide test in one state.

TERM INSURANCE

More people are buying term insurance these days. In 1970, there was $105 billion of term insurance in force under ordinary term policies, some 14% of the total ordinary insurance in force. Four years later, it was $173 billion, some 17%. Industry figures show that term policies sold now account for about 15% of the total and the coverage under them accounts for about 30% of the volume. These proportions are about 50% over those of five years ago.

Why the increase? Inflation, and also, in part, probably the effects of the recession of the last year or two. And contract innovation and price-cutting by insurance companies.

Term insurance is notable for its high lapse rates. The exhibit following shows the lapse rate experience for Northwestern Mutual.

Lapse Rates 1971-74
Term Insurance Policies - By Amount
Personal, Standard Premium

Duration/Issue Age	Male 0-19	Male 20-29	Male 30-39	Male 40-up	Male All	Female All
		5 Year				
1	14%	26%	16%	17%	19%	28%
2	11	15	12	10	12	11
3	10	12	10	9	10	8
4	10	16	12	9	12	13
5	3	8	7	4	6	3
		10 Year				
1	10%	16%	15%	12%	15%	10%
2	3	8	7	5	7	5
3	9	8	6	4	7	4
4	6	6	5	3	5	4
5	4	5	5	4	5	4
6-10	4	4	3	3	3	4
		Decreasing Term - 10 & 15 Year				
1		26%	14%	12%	16%	22%
2		21	12	7	12	13
3		19	10	10	11	7
		Decreasing Term - 20, 25 & 30 Year				
1		12%	9%	6%	10%	9%
2		10	6	5	7	6
3		7	5	5	6	5
		Yearly Renewable Term				
1	15%	19%	13%	14%	14%	27%
2		16	10	18	14	9

These first year term lapse rates are about double those for permanent insurance, and the renewal lapse rates are of the order of three times those for permanent plans. The persistency of the business is further reduced by conversion rates, which are of the order of an additional 10% per year.

There is some tendency, possibly not a trend but a tendency, toward payment of a higher first year commission rate on term insurance, more nearly at the level of or the same as that for whole life insurance. This is partly in response to consumerist pressure (on the contention that a commission rate differential biases the salesman). Since this increases the cost of the product, it would presumably increase the price.

Commissions are presumably paid for the creation of a stream of revenue. They are front-ended in recognition of economic facts of the marketplace.

Expected future revenue per dollar of initial premium is much lower for term insurance than for whole life insurance (because of lapses, conversions, length of the term plan). In consequence, expected commissions over the life of a term contract are a higher proportion of expected revenue than for whole life insurance. An increase in the first year commission rate would mean that the proportion should be higher still.

In product innovation, there is increasing emphasis on renewable term, particularly annual renewable term. We see, also, more flexibility in decreasing term contracts, matching different possible patterns of term period and interest rate for a mortgage or family income curve. Decreasing term offers some cost advantages, too, over renewable term. Even so, the renewable term forms seem to be in the ascendency. We do see here and there "unbundling" in the pricing structure, allowing buyers to choose their own conversion period with an appropriate premium for the conversion option. Policy fees are also getting larger, reflecting operating costs and serving to make larger amounts more attractive.

The most notable phenomenon in term insurance is in the pricing. Here, I would like to substitute an impression for a demonstration: Term premiums are notably lower than they were five years ago, and it didn't come from mortality and it didn't come from expense. Therefore, it comes from a reallocation of overhead, or from lower profits. There are obviously some limitations to this, but companies still seem to be probing for the bottom. As one of our colleagues said in an article a while ago, a company could find itself to be undernourished if it tries to eat soup with a fork. The combination of high lapses (which still seem to be increasing) and increasing expenses is not reassuring. Also, it would seem to be a fair statement that many companies do not as yet have as good an answer as they would like to have on level of mortality that will emerge on the renewal of some of these new forms of term insurance.

MR. ALVIN B. NELSEN: Will acceptance of the rider providing a higher loan interest rate adversely affect the dividend scale? And, if so, will states with and without the 8% rate be differentiated?

MR. JENSEN: We have discussed using several dividend classes to reflect the interest difference by state. However, at this time, we don't see any great changeover which would lead to decreasing dividends.

MR. LEWIS: How are you handling reinstatements when the interest rate has changed?

MR. MURPHY: We are accumulating at 6% to the date of reinstatement in order to encourage reinstatements.

MR. LEWIS: Have any states allowed the use of 8%?

MR. MURPHY: They probably would, but we are comfortable with 6%.

MR. GOLDEN: Does the formula for determining the changes in the policy loan interest rate have to be guaranteed in the policy or filed with the various states and would these formulas tie the loan rate to the prime rate?

MR. JENSEN: I'm not aware of any restrictions that would tie it to the prime rate. I know of only the rules in the model bill, which is not law in every state.

MR. JOHN F. HOOK: Is there a rule to control the correct issue of policies where adjoining states allow different interest rates?

MR. JENSEN: If a person either lives in the state or works in the state, he can buy a contract in the state. Someone living in Connecticut and working in New York has a choice.