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SELECTED INDIVIDUAL LIFE TOPICS

Moderator: ROBERT H. JORDAN. Panelists: PAUL J. OVERBERG, RODNEY R. ROHDA, PHILLIP A. TURBERG

1. Competitive pressures. What are they? How can the actuary respond in ways that are legitimate and not manipulative?

   a. Emphasis on net cost, and impact of terminal dividends and cash value basis.

   b. Movement toward lower premiums and cash values.

   c. Term vs. permanent.

2. Preferred risk/non-smoker policies. Does the introduction of special pricing improve equity? Can discounts encourage better health? To what extent are these special policies a response to competitive pressure? How has experience compared with assumptions?

3. Impact of the field force on product design. What role do they play in the decision to introduce a new product? To what extent does the actuary feel pressured to develop a new product such as Section 79 because some major competitors are marketing it? How is the compensation decision made?

MR. ROBERT H. JORDAN: There has been a flurry of product introductions recently which can hardly be ignored, especially by those whose portfolios have remained unchanged for several years. It appears that many mutual companies will experience a reduction in average premium per thousand in one year that is of the same magnitude as the drop that took place in the previous ten years. In the portfolios I have in mind, such a drop can be caused by the basic rates alone, to which in many cases will be added the effect of new preferred risk or non-smoker discounts. In addition, a dramatic shift to term is a real possibility in Adjustable Life, which could have a further impact on the average premium per $1,000.

At the same time, other related pressures have been building: one is in the consumerist area, exemplified by the Federal Trade Commission's (FTC) recent involvement and pronouncements; another is in the Advanced Underwriting area, where interest has grown in quantum leaps in products for special market areas such as Section 79, Retired Life Reserves, Business Insurance and Multi-Life Estate Preservation.

The good old days of offering a bland, straightforward portfolio and taking the Travelers' or the Metropolitan's rates and subtracting 10 cents are so long gone that it is probable many Society members have not even been aware they existed. The whirlwind of recent new product introductions has really had its impact. The need to be competitive is real but whenever a new product or a rate change is contemplated, each of us can legitimately ask such questions as these:

What does the expression "be competitive" mean in the case of our Company and how far do we have to go?

How will we be able to retain the margins that are needed to meet our profit or surplus objectives?

Since our products stay on the books a long time, what is the long term as well as the short term impact of this proposed change on profits, on administration, on our ability to be flexible, etc?

MR. PAUL J. OVERBERG: Twenty years ago, yes, and even 10 years ago, it was quite stylish for actuaries to discuss how easy it must be for agents to sell life insurance, since rarely was there any price competition. We would admit that, on some few larger cases, face-to-face competition did exist. Various studies had shown that most Americans were underinsured, so all the agent had to do was point out to the customer the fact that he needed life insurance, and then convince the customer to allocate the funds to pay for it.

Today, some critics of the life insurance industry are saying the same thing. Even though there are 1,700 life insurance companies, they say there is very little competition involved in the selling process of personal life insurance.

Perhaps there are some people in this audience who agree with these critics. But for those of you who work with your Marketing or Agency Department, and who get out there and talk with your agents, you begin to sense that there is price and cost competition and that these competitive pressures are intensifying.

The pressures come first and foremost from our own agents. Agents are becoming increasingly aware of how their Company's products stack up with those of other companies. But even the customers are more aware of price shopping than I have ever known them to be before. This customer awareness is especially noticeable in the sale of term insurance and flexible premium annuities.

Competitive pressures also arise from group insurance, savings and loans, and other financial institutions, and one of our biggest competitors is that of trying to convince a potential customer to buy or retain his life insurance policy rather than some tangible product, such as a television or a car.

In the last 5 to 10 years there has been:

1) A revival of the "Buy Term and Invest the Difference" advocates, and

2) The publication of numerous life insurance shoppers' guides.

The "term-advocates" include FTC staff members and, more recently, the NATLU - that is, the National Association of Term Life Underwriters.

The shoppers' guides usually compare whole life-type policies and five year renewable and convertible term policies.

They often use the National Association of Insurance Commissioners' (NAIC) four cost indexes in making their comparisons.

There are some indications that these guides and term advocates may have increased the consumer and agent awareness of "cost" consciousness of life insurance products.

Cost, in its simplest form is often interpreted as the amount you have to write the check for. And, perhaps, this has been at least a partial explanation of the trend for more than a generation of the move towards lower premium per $1,000.

Similarly, the trend toward the increasing popularity of guaranteed cost insurance may also reflect agent and consumers' awareness of the size of the initial premium.

At the end of 1972, 65% of all ordinary insurance in force was on a participating basis. Five years later, at the end of 1977, only 60% of the ordinary in force was on a participating basis - that's a five percentage point drop of in force in only five years.

Perhaps the low going-in rate of the guaranteed cost contracts may also have influenced many of the mutuals to come out with, and emphasize, their economatic and extraordinary life-type policies in order to give their customers a similar, and sometimes lower, going-in price than the traditional guaranteed cost whole life-type product.

We are all aware that there has been a trend toward term. This trend has accelerated in the last several years, but it has not detracted from the sale of whole life insurance.

"Ordinary" Life Insurance
Purchases in the United States
by
TYPE OF POLICY

	% of Amount			1972 to 1977 Change
	1967	1972	1977	
	%	%	%	% pts.
Whole Life	25	26	26	0
Other Life & End.	19	20	14	-6
Family Plan (with & without Term Riders)	19	16	12	-4
Combination	16	15	14	-1
Level & Decreasing Term	21	23	34	+11
Totals	100	100	100	0

This table contains data taken out of the Life Insurance Fact books. It shows the ordinary life purchases in the United States by type of policy for the calendar years 1967, 1972, and 1977. The first line shows the whole life-type policies. It shows that the industry's sales of whole life-type policies were fairly constant over the last decade at about one-fourth of all sales.

Now look at the first two columns 1967 and 1972. Note how the mix of business by type of policy in 1972 was very similar to that of 1967.

Now compare 1977 with 1972. Note Term Insurance. In the five years from 1972 to 1977, Term Insurance increased 11 percentage points, and an offsetting decrease occurred in other life and endowment and family plan-type products. But - as mentioned earlier - Whole Life held level at 26%.

No one can say for sure what caused this change. But, at least coincidentally, it was during the same five year period that we had considerable renewed activity on "Buy Term and Invest the Difference" and on the publication of shoppers' guides which featured whole life-type products, and five year renewable and convertible term products.

In fact, it was April, 1972, when Herbert Denenberg, then Insurance Commissioner of the State of Pennsylvania, published his first life insurance shoppers' guide.

One of the well known investment firms made a study last year of the average premium charged for whole life and five year renewable and convertible term products over the 25 year period, from 1953 to 1978. Their study was confined to guaranteed cost contracts issued by stock companies. It showed that the premium charged for whole life policies in 1978 ranged from 70% to 85% of what they were in 1953, and that the premiums for a five year renewable and convertible term in 1978 ranged from 50% to 65% of what they were 25 years earlier.

The change in the whole life premium can be explained by the increase in the net rate of return on investments. During this 25 year period, the industry-average rate of return doubled - from 3.4% in 1953 to 7% in 1977.

But this does not explain why the term rates dropped by as much as 50%. The inflation in expenses has been much more dramatic than the improvement in mortality. Thus, one might have deduced that - in the absence of competition - the premiums for term insurance should have remained relatively constant over the last 25 years and perhaps even increased over the last 10 years.

The next portion of my discussion deals with "Legitimate" versus "Manipulative" ways in responding to competitive pressures.

Unfortunately, or perhaps fortunately, the program for this morning's meeting did not define the words "Legitimate" or "Manipulative". There is an NAIC advisory committee which is led by Mr. Julius Vogel of the Prudential that is studying this very question. Its task is to determine:

1) What is manipulation;
2) How to detect it; and
3) Once you detect it, what should be done about it.

In an effort to determine a definition for manipulation, this committee has turned to the various publics and asked for suggestions of a meaningful definition of manipulation. Each of you has been requested for your definition in the current issue of The Actuary, including any examples of policies which you feel have been manipulated. Mr. Vogel is anxious to have your definition of manipulation.

The NAIC model has been criticized as being subject to manipulation. Until we have the definition of manipulation, we really cannot determine how valid the charge is.

In the meantime, regardless of the definition of manipulation, there are a few items that should be kept in mind:

1) The NAIC model regulation on cost disclosure requires us to give the potential customer the 10th and 20th year net payment cost indexes and the 10th and 20th year surrender cost indexes, and

2) The potential customer can be expected to assume that the 10th and 20th year cost indexes are representative of similar cost indexes, computed at the years immediately preceding and succeeding the 10th and 20th years.

If such is not the case, perhaps the customer should be so alerted.

Furthermore, whether such discontinuities are an indication of manipulation could be a matter of a discussion between the company actuary and the Insurance Department.

The final point is a very basic one. Any effective cost disclosure system - and I emphasize the word "effective" - whether it be for life insurance, auto insurance, air conditioners, or new cars - will encourage the seller to tailor his product to look its best when measured on the regularly prescribed basis. It is naive not to recognize this basic fact, and you as actuaries would not be doing your jobs if you did not so respond. Furthermore, in my opinion, such responses should not automatically be considered manipulation.

MR. RODNEY R. ROHDA: In my position in a mutual company, I face at least four different types of competitive pressures with regard to individual life products.

1) From the big hitters in the field when they lose a multi-million dollar case to the "What's It" policy written by "Whose It" life. Naturally, the claim is that we should introduce a "What's It" policy by tomorrow morning. Many battle scarred veterans have already learned that by the time your own "What's It" is out, there is a good chance that nobody will want it or remember why you developed it to begin with.

2) The second source of pressure comes from having a major competitor publish a list of the 15 most competitive products in the New York Times with their own company naturally shown in first place. If any of you have not seen these ads, my friends in the field have sent me at least 200 copies which I would be happy to share with any of you.

3) The third source is actual trends in competitive sales situations which are felt by your field force in a variety of markets and geographic locations. It is extremely difficult to separate the occasional unique competitive problem from an underlying trend, but being able to make this distinction is a challenge which we must face.

4) The last is actual home office analyses of competitors' new products in comparison with your own. These studies are somewhat unique from the above three in that they are usually based on complete, correct, and up-to-date facts.

In his introduction, Mr. Jordan referred to the flurry of product introductions and the dynamic changes taking place today. I could not agree more. I can faintly remember in my younger days complaining that nothing new ever happened in our industry. I am still complaining, but the gripe is now that too much is happening.

Mutual Benefit operates primarily in the upper income markets in the larger metropolitan areas through a full-time general agency field force. To give a concrete example of the competitive climate in our marketplace, I will focus on a comparison of ourselves with 14 mutual company competitors. Ten of the companies in this study are among the 20 largest life companies based on assets and all 15 have assets of at least $1.5 billion, with half having assets between $3.5 and $8 billion.

Ten to twenty years ago, the competitive focus for mutuals seemed to be on the 20 year traditional net cost. About ten years ago, the 20 year interest adjusted index (IA) began to be used but mostly in home offices and in scattered state insurance departments. In the past decade, the 20 year interest adjusted cost index has become the accepted measure of competitive position except, perhaps, in upwardly mobile regulatory agencies like the Federal Trade Commission.

Age 45, $100,000 or More
Premium per $1,000
Preferred or Best

	Company	
1.	A	$23.07
2.	B	23.23
3.	C	23.76
4.	D	23.93
5.	E	26.42
6.	F	27.20
7.	G	27.66
8.	H	27.76
9.	I	28.41
10.	J	29.14
11.	K	29.39
12.	L	29.50
13.	M	30.50
14.	N	30.69
15.	O	31.74

Now, we, in mutual companies are suddenly discovering a new number to focus on -- the going-in premium. This chart shows the premium per thousand for 15 mutual companies at age 45 for the lowest cost whole life contract of each company. You will note that companies A through D are in a class by themselves with premiums between $23 and $24. The remaining eleven are scattered over a fairly wide range from $26.42 to $31.74 per thousand. Only one of the top four companies had this low rate two years ago. It is rare that the Wall Street Journal pays much attention to product introductions of large mutual life companies, but even the Journal covered the news of the recent substantial cut in premiums.

Age 45, $100,000 or More
20 Year Interest Adjusted Cost
Preferred or Best

	Company	
1.	F	$3.42 *T
2.	M	4.81 *T
3.	N	5.33 *T
4.	G	5.42 *
5.	B	5.50 *T
6.	E	5.61 *T
7.	A	5.90 *
8.	H	6.11 *T
9.	D	6.13 *
10.	C	6.21 T
11.	K	6.28
12.	J	6.59 T
13.	I	7.10
14.	L	7.52 *
15.	O	8.72 T

* Preferred Risk
T Terminal Dividend

This chart shows the 20 year interest adjusted cost indexes for the same 15 policies. The letter designations given the companies on the first chart have been retained here. That is, Company A has the lowest premium and O the highest. You can see that rankings based on premiums and those based on 20 year IA's differ significantly. Companies M and N were 13 and 14 based on premium, but 2 and 3 based on the 20 year Interest Adjusted Index. One company is in a class by itself based on 20 year interest adjusted cost of $3.42. The number two company follows at $4.81 with a clustering of the third through twelfth companies between $5.33 and $6.59.

While I was unable to get the exact figures that applied two or three years ago for each of the companies, the $5.74 index of the first place company at the end of 1976 would now be only good enough for seventh place. As an example of the recent decrease in cost, Company A dropped from $7.40 to $5.90 over the past two years because of the combination of dividend scale increases and the introduction of a preferred risk program.

Yes, there have been substantial competitive changes in the past two or three years. Of the fifteen companies shown here, ten now offer preferred risk programs with six of the ten having been introduced within the past two years. Mr. Overberg stated that such programs give only a "slight" competitive edge. I feel that this edge is more significant. Nine of the 15 pay terminal dividends (TD) with one of these nine having made the move to TD's on January 1st of this year.

How does a company respond to this competition if it is not now near the top of these lists? One answer is to introduce a new 4% modified reserve series with premiums reduced 15% to 20%. But before doing this, considerable time should be spent in evaluating the impact of this on the compensation of the field force. Does a 20% reduction in premium mean a corresponding reduction in field compensation? This question is bound to lead to some interesting field-home office arguments.

Turning from the premium level to the 20 year interest adjusted index, what can be done to improve it? Two possibilities are the introduction of a preferred risk program and a steepening by policy year of the dividends and cash values, which includes as a subset the payment of terminal dividends.

Before discussing these in more detail, we must consider if these or other moves to improve the 20 year competitive position may be classed as being manipulative. I am sure that many of you have read in one of the trade publications about one company that introduced a special policy which has a uniquely favorable 20 year index, but at both earlier and later durations was not nearly as competitive. This clearly falls within Mr. Overberg's definition of manipulation. I am happy to say that such examples of outright manipulation have been few and far between -- at least among the major companies.

What about improving your competitive position by introducing a preferred risk program? In my view, such a program serves to improve equity among policyholders. For a number of years I have been puzzled over our industry's practice of charging the same cost of insurance to the 90% or 95% of our applicants who qualify as standard risks but imposing a staggering array of special class premiums and extras on the few who are substandard. The expected longevity of the best standard risk substantially exceeds that of the applicant who just squeezes in at the bottom of the standard group.

It is virtually impossible today to miss the messages coming from all of our media regarding the benefits of not smoking and other habits which help to achieve good health. Our industry has been criticized for not having moved more quickly in recognizing through our pricing the benefits of not smoking. However, we have at the same time seen certain regulatory actions in the property and casualty field which require the same rate for all risks irrespective of their differing characteristics.

Will a program of preferred or non-smoker discounts encourage better health? Although it might, I honestly do not think this will happen. Overall, I suspect that a company which introduces such a program today will experience approximately the same aggregate mortality. However, the Company will be able to more equitably reflect differences by risk classification.

Should the improved mortality of preferred risks be reflected in the premiums or dividends? All but one of the ten companies in our list with preferred programs passes the savings along through a lower premium. I suspect that the primary reason for this preference lies in the simplicity and immediacy of the premium discount route. However, this approach offers less flexibility in adjusting to experience than the dividend differentiation approach. No matter whether the premium or dividend route is taken, you are still left with the necessity of somewhat arbitrarily selecting the amount of discount since there is little in the way of concrete statistics at this point.

What proportion of your applicants should qualify for the preferred program? This is obviously a potential area of abuse. Why not set extremely rigorous requirements for which only 1% or 2% of your applicants can qualify, which will allow a terrific IA index to show off? You could call it the Superperson Plan or the Shoppers Guide Special. I am not now aware of any such abuse of this nature. It appears that most companies' programs have been structured so that at least 1/3 to 1/2 of standard applicants will qualify.

What about the move toward a steepened pattern of cash values and dividends? As with the preferred risk program, I feel that this trend also improves equity among policyholders. The losses incurred by early terminators of permanent insurance must be borne by those who persist. To the extent that we make it easy for our policyholders to bail out early by offering relatively high early values, are we not promoting a potentially inappropriate sale of permanent insurance?

There might be a self-fulfilling prophecy here -- if you make it too easy to lapse early, you will get more early lapses. Has the tendency towards a lower scale of early cash surrender values and dividends been carried to an extreme? In looking at our major competitors I do not think that this is true. Yes, there are lower early cash values today, and yes terminal dividends might be getting more attention than in the past but after reviewing the actual facts of today's products no one can raise a claim that we have gone back to a Tontine concept.

What impact does the field force have on product design? In making my remarks on this aspect, I am struck by the diversity in the background of the individual members of the audience. To the younger members my remarks might appear callous and to the older members, too naive. With that as background let me advance a few thoughts.

1) To survive and prosper in life insurance sales, your focus must be on today. This tends to create a problem in home office - field relationships regarding products. It is difficult at best to get a successful agent to focus today on the details of a product which will not be available for two years. While they do not pay much attention to it when it is in its design stage, they usually have a lot to say about how it should have been designed once it is ready to go to market and it is too late to change.

2) Second, do not plan on making your decisions based exclusively on a majority vote from any field force group on any subject. Every company's field force is made up of a variety of different personalities dealing in widely different markets. Ask them about a proposed premium level. Half will think it is too low and the other half will think it is too high. The buck inevitably has to stop with top management.

3) Third, despite the problems pointed out above, do not create products in a home office vacuum. Get involved with your field force and listen with a sympathetic yet critical ear to a cross-section.

4) Last, when it comes to products, do not try to be all things to all people.

Dealing with today's competitive pressures is made vastly more difficult by the financial environment in which we are all now operating. There is no denying that our industry is faced with the prospect of substantially slower future growth in gains from mortality and investment improvements coupled with inflationary expense levels. Surplus ratios have decreased from historic levels. Most companies have moved from a net level to a modified reserve basis so that statutory earnings can more properly reflect the actual incidence of expenses. We have all been told by our elders to be sure that we do not give the store away in our product development and pricing. Mutual insurance companies must of necessity pay more attention to their bottom lines today because of the overall environment. The challenge of meeting the competition, and simultaneously assuring that our products are self-supporting and equitable between generations of policyholders, should keep all of us from complaining about boredom.

MR. PHILLIP A. TURBERG: Are competitive pressures intensifying? What creates these pressures? What is the involvement of the various publics we deal with? And most importantly, how do we respond to them?

Inflation, inadequate pricing and increase in earnings demands are prime factors that contribute to competitive pressures on the actuary. These three factors are interwoven into the fabric that produces competitive pressures for the actuary. Inadequate pricing is the result of a basic conflict - the inability to properly reflect inflation of expenses and agents compensation in the rate structure and also satisfy the needs for growth in sales. Increase in earnings pressures can be satisfied by increased sales and use of optimistic GAAP assumptions and creative reinsurance arrangements. These tend to hide inadequate pricing. If you are to increase earnings at acceptable levels and cope with inflation, you generally cannot have competitive prices. Yet the actuary is called upon more and more to produce this feat.

Now let us look at who creates these pressures. The Chief Executive Officer (CEO) needs as a key objective increases in earnings to satisfy shareholders in a stock company and to show at least some stability in surplus in a mutual company. A common assumption is that the easiest way to accomplish this is through increased sales. He sees his competition becoming more competitive in the marketplace and therefore feels that his own staff, particularly the actuary, should be able to achieve similar

results. Under pressure for results he will accept relatively low profit margins and asset share results that require many years for the recovery of invested surplus. If profits fail to materialize due to adverse experience, the actuary will be held accountable. If experience is better than expected, the CEO will accept the credit for taking the risk despite his actuary's extreme conservatism.

Probably the major source of competitive pressure comes from the chief marketing officer. He faces an unusual dilemma in that his success is based on increased production. This requires greater expenditures of money on both agents' compensation and marketing support systems. But his job is made easier if he also has competitive rates -- not the best; one penny per $1,000 over the best will do. Who better to put pressure on than the actuary. He holds the key to solving all the problems if he would only reduce rates and increase agency compensation.

In recent years another source of competitive pressure is created for the actuary by the underwriter. Inflation in underwriting costs and field pressure for simplicity combine to create pressure to eliminate unnecessary nuisances such as medical examinations and other forms of underwriting tools. Underwriters tend to support more liberal nonmedical limits and reliance on less information to facilitate their ability to deliver the product to the field and assure that they meet their budget. It is, again, the actuary who is asked to justify these liberalizations in areas where little statistical support exists for these decisions.

No one is suggesting that these are all of the pressures or that they exist simultaneously in every company -- after all, some CEO's, underwriting officers and even marketing officers were trained as actuaries. However, most actuaries have felt this type of competitive pressure in recent years and it is probably increasing.

The regulatory agencies have provided another source of competitive pressure to actuaries. Insurance departments with the lack of consistency in regulation tend to create competitive woes for the actuary over which there is little control. The New York vs. non-New York company problems are well known, but there are significant operating difficulties between domestic and foreign New York companies. An Oklahoma domestic company operating nationally is in an adverse competitive position because of retaliatory premium tax statutes.

A good example of the pressure on the actuary from this source is the question of writing a Group product on a group in a state where it does not qualify as such under the state's Group Insurance laws. The use of an out-of-state Group trust to provide this coverage raises some interesting questions. The actuary that interprets the law by its intent would not go along with providing that sort of coverage. However, competitors will not be so pure. This leaves the actuary very often in a very unpleasant situation.

There is also the question of whether an Ordinary product which is subject to deficiency reserve requirements is also subject to those requirements if it is written as a Group product. Requests for clarifications from insurance departments tend to be rather confusing. Frequently when they are negative they are not enforced beyond the company asking for the clarification.

The Internal Revenue Service is another source of consternation to the actuary. This is painfully evident in the Section 79 premium split question. Uncertainties of the tax status of certain reserves as life or non-life creates uncertainty in product pricing, too.

Clearly, agents continually want new things that are easier to sell and there is little need to go into the pressure that they exert. However, it should be noted that the compensation of agents in an inflationary society, with ever-decreasing premium rates, has made it much more difficult for agents to come into the business and survive. In contrast to the casualty agent who has basically an inflation proof income, the life agent is facing a rather severe test of his ability to survive. The actuary should not overlook this point in evaluating agency compensation decisions.

Consumers, and particularly the consumer groups, are another source of pressure to the actuary although this is not felt as directly now as it may be in the future. Managements are becoming more aware and concerned of these consumer complaints and are becoming responsive to them. This is not to suggest that this response is always positive since it may create pressures for pricing reductions and form simplifications that will undermine the solvency of the business.

How does the actuary respond to these pressures and how does he do it in such a manner that is productive to his organization, policyholders and himself? First, there has to be clearly stated profit and pricing objectives at the corporate level and the actuary must have a role in formulating and monitoring those objectives. These corporate goals must relate to the types of products the company will offer, profit or surplus needs, distribution systems available and processing capabilities. There must be an established process for the development of products and their introduction. The process should deal with the reality of such endeavors including realistic time frames and expenditures for completion of the various stages in the process. The company that sets a profit objective of a certain return on investment over a certain number of years should use realistic expense assumptions in the development of those products and not assumptions which may be realizable many years hence. This, of course, relates to mature organizations.

There must also be clarity in the role of the actuary within the organization. What is he expected to produce, what are his accountabilities, and how is he to be measured for performance? Often major marketing decisions are made without consulting the actuary. It is then the actuary's role to make something work which may not be possible within the corporate objectives and corporate framework. This tends to create a role for the actuary of being the "spoiler" or the "negative" source of management.

Frequently this problem is the result of poor communication with other department heads, chief executive officer, field people, etc. The actuary must make an effort, probably more than other department heads, to communicate his capacities and needs as he sees them to all other interested parties. He must attempt to make this communication in as positive a manner as possible taking into account other department heads' needs, concerns and limitations.

It is important for the actuary to recognize the multiple role that he plays in a corporation of being a professional, a manager and, to some extent, an entrepreneur. It is probably the most complex competitive role and therefore the least understood role within the life insurance organization.

On the matter of developing preferred risk policies, I will briefly describe a policy that we developed with a client company domiciled in New York State. The management of this company several years ago became intrigued with the idea of providing a more competitive product to individuals who regularly participated in strenuous physical activities such as jogging, tennis, swimming and water skiing. We designed a policy with a special dividend class for people that met certain qualifications. The special dividend class approach was selected because:

1. we did not feel that we had sufficient statistical data to properly anticipate the reduced mortality level, and

2. we were concerned about the deficiency reserves.

It was further the feeling of the management that annual physical examinations were to the benefit of the policyholder and should be encouraged. This could also give us an opportunity to find out if the individual in a special dividend class was continuing physical activities. The policyholder would only receive dividends in the special dividend class if evidence was submitted that he had taken a physical examination.

The company would not get the results of the physical examination, but, hopefully, would get an indication on the verification form as to whether physical activities were continuing. However, even if physical activities were terminated, submission of evidence that the physical examination had been taken would qualify the individual for the better dividend class rate. If the individual did not submit, he would get dividends on the standard dividend scale. Part of the sales approach would be that the dividend differential could be applied to pay part or all of the physical examination for the individual.

Unfortunately, after a long period of negotiation, the New York Insurance Department would not approve the special dividend class approach. The Department was understanding about the limited data that we provided to them which illustrated potentially significant reductions in mortality, particularly for ailments related to cardiovascular diseases among groups that had engaged regularly in strenuous activity in either their vocation or avocation. They were willing and did approve a discount for individuals who exercised regularly. Although non-smoking is considered a positive condition, it is possible the way the discount is set up that an individual could be a smoker and still have sufficient other physical activities to qualify for the special discount rate.

A schedule of credits was developed for the individual activities that appear in the application. If an individual achieves sufficient credits he qualifies for the discount.

Sales response to date has been rather modest but picking up lately. It has been an aid to the company in attracting new agents. Since the company does not have a controlled agency force, the results of this will take some time to be fully effective. There is some hesitancy on the part of agents in submitting applications because the company has been very careful not to indicate its underwriting criteria and how it is selecting individuals.

Consistent with the company's commitment to this discount which covers all of the permanent policies of the company, it has developed an advertising campaign, using a nationally known athlete as the focal point. The company has also sponsored a roadrace and an annual tennis tournament. It has provided its employees with a fairly comprehensive exercise facility in its home office.

Concerning the role of the field force on product development, it seems to me that they should have a primary role as the source of new product ideas. Most of these will come from actual competitive experience and other companies announcements. Generally speaking, I believe that products developed exclusively by home office people are artistic successes but production failures. I cite variable life insurance, variable annuities, and possibly the adjustable life as concoctions of home office people that may not address consumer understanding and needs. The field should also have substantial input in the design of proposal forms to be used in the field and field support material that is required.

The pricing of products must rest exclusively in the home office. Products have to fit established corporate guidelines for product development and they must be compatible with the company's distribution system, administrative system, profit objectives, surplus availability, and its overall corporate image. It is expecting too much of the field force, particularly a non-captive field force, to provide meaningful input into the actual pricing and design of products. This has to be communicated to the field, hopefully by field management, and they must support product development guidelines.

An interesting development in recent years has been the special product or lines of business for a particular agency or marketing source. This is a practice which should be encouraged only under very unusual circumstances and only where the source has substantial sales potential. There should be a total commitment to the company that is providing the product by the agency.

The motive behind the arrangement has to go beyond mere financial considerations. This can be company image, service facility, surplus availability, or some valid reason why your company is the lucky partner.

These arrangements should only be considered when it is evident that they will not be competitive with the existing agency force or divisive in requiring too much management time so that other marketing ventures are downgraded.

MR. ERNEST J. MOORHEAD: Mr. Overberg included the FTC among the term advocates with which he believes the life insurance business must contend. I consider that the FTC has successfully resisted the temptation to be a term advocate. Their objective is just to make sure that the enthusiasm of so many companies and agents for whole life does not result in buyers being unaware that term is among the choices available to them.

Mr. Rohda's reference to terminal dividends moves me to emphasize that the existence of terminal dividends, even of substantial sizes, should not in itself be tagged as a form of manipulation. Terminal dividends, I think, can be given a clean bill of health provided (a) they are supported by asset shares reasonably constructed, and (b) their patterns both before and after the twentieth policy year free them of any charge that they have been created for the purpose of sweetening the twentieth year interest-adjusted index.

Mr. Turberg may or may not be aware that an article in the April 2, 1979 issue of Forbes expresses a view about stockholder vs. policyholder orientations of some life insurance companies that is not at all in harmony with what Mr. Turberg said.

Turning to the definition of "manipulation", may I first mention that this unpleasant charge has been levelled at actuaries since at least 47 years ago. In his discussion of Henry H. Jackson's paper, The Wisdom of Mutual Life Insurance, Mr. Arthur Pedoe wrote (see XXXIII T.A.S.A. 445):

> "For years the Contribution Plan of Dividend Distribution has been manipulated so as to increase the dividends to newer entrants at the expense of the policies of longer durations and especially of the paid-up policies."

Perhaps I can assist this morning's discussion of manipulation by reading my attempt to convey to students what the word means. It is contained in my submitted revision of the chapter on Competition in the Study Note on Marketing of Insurance Products. I do not yet know whether what I wrote has been accepted by the Education and Examination Committee:

> "Since 1972 regulators have repeatedly raised the question whether buyers may need special protection against manipulation by actuaries designed to thwart the purposes of cost comparison. Regulators are giving increasing attention to both (1) patterns of cash values and dividends that differ from prevailing patterns in ways not clearly identifiable with the interests of policyowners but leading the uninformed to suppose that the policy is more attractively priced than it really is, and (2) policies designed to be "competition-proof", i.e., differing in structure or packaged in such a way as to defy or complicate comparison by prevailing methods."

The last part of this description should not be interpreted as meaning that policies consisting of unusual packages of life and term coverages will necessarily be branded as being manipulative. But actuaries must expect to be quizzed if the formulas they adopt for calculating premiums on such packaged contracts strike observers as being inconsistent on the upward side with the formulas they use for policies that are easily compared with other companies' policies by the interest-adjusted method.

MR. OVERBERG: I was careful and I believe Mr. Moorhead was careful to note that I talked about the FTC's staff members. I believe that most of you who have read any of the prior publications of the FTC's staff members would agree that they have favored term.

MR. ROHDA: With regard to the reference of terminal dividends, I would totally agree that the concept of terminal dividends can hold up. The New York regulation on terminal dividends states that they must bear a reasonable relationship to the annual dividends. I am not sure if they go any further than to say just a reasonable relationship.

MR. TURBERG: I understand the Forbes' article points out that life insurance companies are a great investment. I think you will see most of the acquisition activity has been taken either by other insurance companies or by foreign insurance companies. We have many large corporations in this country sitting with literally hundreds of millions of dollars that want to invest in life insurance companies. I am talking about industrial firms primarily, and most of them later discover the return on investment is too low. I do not think that insurance companies are a very good investment source.

MR. ROBERT M. ASTLEY: On the question of the treatment of smoking vs. non-smoking, I would like to report what the Mutual Life of Canada is now doing. About three years ago the company looked very carefully at the possibility of introducing non-smoker's rates. The Surgeon-General's report clearly indicated a substantial difference in mortality between smokers and non-smokers. A committee to study the question was set up, including an actuary, a doctor, and an agency representative. The conclusion finally reached was that smoking was simply another factor to be considered in the underwriting process. It was perhaps the most significant factor which had not yet been recognized, but none the less we viewed it as one of many underwriting factors. Accordingly, we added questions about the extent of smoking to our applications and devised a scale of credits for non-smoking and debits for varying degrees of smoking. These credits and debits are then applied in the traditional underwriting process.

One of the considerations in moving in this direction was the problem which would be faced on existing convertible term insurance and guaranteed insurability options. What would be the new standard class if we adopted a preferred rate for non-smokers? The former standard class would presumably be worse than the preferred non-smokers class, but would be better than the standard rate for smokers. The easy solution would have been to place such persons into the smokers class unless the person was able to provide evidence that he was not a smoker. However, this approach appeared to us to be at odds with the implied commitment to a convertible term policyholder that we would give him the standard class rate on conversion. What are those companies which offer a non-smokers rate doing in this regard?

I agree with the panelists that the fundamental question is not non-smokers vs. smokers rates, but whether or not it is wise and proper to subdivide the current standard class into smaller classes.

MR. ROHDA: A practice I have seen some of our competitors engage in is that when a term contract is underwritten and issued today, there is a notation made on the term policy record as to whether or not the policy would qualify for the preferred discount. Those policies which originally qualified for the discount would then be able to later convert to a preferred permanent plan.

MR. OVERBERG: Back in the early 1950's the preferred risk policy was one approach of charging less for the larger size policies. At that time we inserted in our term contracts the qualifying words "standard issues".

MR. TURBERG: The Company I earlier discussed has very little term conversion exposure in this area but I propose that the practice you might want to follow would be not to permit an older policy to convert to a preferred discount without some sort of evidence that the individual actually qualified for it.

MR. THOMAS J. KELLY: In New York, we have allowed a modest premium discount for non-smoker policies. I would like to know, however, the extent to which a company checks to see if its applicants are telling the truth in regards to their smoking habits. And secondly, I would like to know if the companies have made any mortality studies of the people who have received non-smoker discounts.

MR. WILLIAM H. MAWDSLEY: State Mutual has offered discounts to non-cigarette smokers for fifteen years. At first this discount was available on only a whole life plan. In 1972, non-cigarette smoker discounts were made available on a total of three permanent plans. In 1976, the non-cigarette smoker discount was extended across the board to nearly all term and permanent plans of insurance. As of January 1, 1979 separate dividend scales have been introduced for all non-cigarette smoker plans.

The extension of discounts to non-cigarette smokers was done in the interests of equity. This program has always had the full support of the actuary.

We are currently compiling our fifteen years of experience with non-cigarette smoker insureds. We expect to submit our findings in a report to the Society of Actuaries in the near future. This study will support the results of the government's studies on smoking in the general population. Our data are still somewhat limited, and although they will reveal significant overall differences, they may not include issue age/duration specific mortality rates that are statistically significant.

In answer to the question on term conversions, our current practice is that an insured may present a non-smoking statement at conversion and we will allow conversion to a non-smoker plan. As for verification of smoking status, we rely upon our agents and the applicant himself. If, for some other reason, an inspection report or Attending Physician's Statement is ordered, the information it offers with regard to smoking would certainly be reviewed.

MR. ROBERT S. ROUFFA: We too have been writing non-smokers discounts for a number of years. Although we are not yet ready to publish our data, I can say that it is very significant and there is obviously quite a difference in mortality between our non-smokers and smokers policies. On the question of verification of non-smokers, we do routinely check the non-smoker's statement and obtain an inspection report verifying that information.

MR. ROBIN B. LECKIE: The life insurance process has worked very effectively by considering 90 to 95% of the population as a single classifiable group which can be fairly easily administered and for which selective information can be obtained without going through a very very detailed underwriting process. I appreciate that in the remaining 5% there are very detailed classifications but the reason for that is because this is the group which can exercise anti-selection against the company. Now we are moving into a categorization of our standard group which is going to lead to ever and ever more classes. We are forced to do this through competition whether we like it or not. I contend, however, that most of these preferred risks policies are brought out not for greater equity but for a better net cost position. I really feel that it is time that we stop to consider if what we are doing is in the best interest of pure actuarial science. Now I appreciate that we could break down to many very fine classes. It is interesting that we are going against what seems to be happening in the casualty side of the industry. I just wonder if we are going to have a break down in the life insurance process by expanding to these additional classifications.

MR. HAROLD G. INGRAHAM, JR.: I sincerely believe that the evidence concerning mortality differentials of smokers and non-smokers is quite significant. It cannot be ignored. I appreciate the argument that you want to be very careful not to completely fractionate your classifications, but I do think that in the case of smokers we have emerging evidence of higher rates of mortality. So that risk classification is valid.

MR. ROHDA: I would just like to make a comment related to both Mr. Leckie's and Mr. Ingraham's observations on preferred risk. Robin, I agree with you that in the preferred area there is potential for abuse. As I see what is being done among the major companies in the preferred program, I feel that there is an honest differentiation. I agree with Mr. Ingraham that there is enough evidence of difference in experience to justify taking that 90% and going 40% preferred and 50% standard, or doing something similar to this.

MR. JAMES F. REISKYTL: I have two comments on the preceding discussion of the preferred risk/non-smoker policies. First, how refined should any classification system be? Is there a practical limit on how accurately the underwriter can subdivide potential insureds? The current preferred risk/non-smoker premium differentials typically are about 1/4 to 1/2 of the extra premium for the first substandard class. If preferred risk applicants can be selected this accurately, does that imply that companies intend to (or should) refine their substandard classifications to put them on a consistent basis? Has any company done this? I believe that differentials generally should be initially established on a conservative basis. Is this the current case? Are these likely to change? To increase?

My second comment is that if the insured smoker/non-smoker mortality experience is as significantly different as described by the previous speakers, perhaps smokers ought to be classified as substandard risks rather than non-smokers as preferred risks -- the data mentioned suggests smokers ought to receive a two or three class extra rating. Earlier Bob Astley mentioned that after some study his company had decided to go in this direction. They recognize smoking as an additional factor in the underwriting process rather than use it as a basis for preferred risk. I don't know if they actually classify anyone, however.

The extra mortality associated with smoking may be greater than that of many other impairments we currently use to rate applicants. With increasing emphasis on credible data, it appears that if this current experience data were to be published, some changes in our current practicies might be required. Would anyone on the panel or in the audience care to comment?

MR. ROHDA: The comment was earlier made that some companies are finding 2/3's of its applicants are non-smokers. I worry that if you rated smokers, you will find the proportion of non-smokers going up to 90%.

MR. ALLAN R. JOHNSON: While our company has not yet come to any firm conclusions as to how to deal with the apparent differential in smoker/non-smoker mortality, I would add to the points made by previous speakers that regardless of practical difficulties we must not overlook the matter of underwriting credibility.

Among my acquaintances, those who smoke admit that they subject themselves to some extra mortality risk regardless of the tar and nicotine content of their brand while those who do not smoke believe and proclaim the significant mortality differentials between the non-smoking and smoking populations. The underwriting process is now being examined as never before by legislators and regulators in response to pressures applied by consumer and other special interest groups. If the public - the standard population - accepts that there is a significant mortality differential between smokers and non-smokers, we must reflect that in our selection process if we are to maintain credibility.

MR. WILLIAM A. ZEHNER: In the fall of 1978, Unity Mutual introduced the Fit Person Discount applicable to most of our permanent plans of insurance. The data on fitness available to us indicated that a mortality saving in excess of 25% of standard could be realized, hence, we intended to provide a reduction in premium reflecting such savings. As a compromise with the New York Insurance Department, we were able to obtain a premium reduction equal to 3/4 of one permanent substandard extra table rating.

Since this is an experimental program, we have established separate plan codes for these plans so that we could monitor the experience as significant exposure is developed. Further, this enables us to establish a separate dividend class if and when it can be shown that mortality savings in excess of those reflected in the premium reductions have developed. Thus, it is anticipated that we may be able to reflect mortality experience in the dividend formula when such can be justified.

We believe that although it is possible for a physically fit person to discontinue activity, the dividend class is created at issue and physical activity at some future time should not be a criteria for removing one from a fit person class. Although activity may cease at some time in the future, we believe that there is a greater chance for one who is physically fit at time of issue to be physically fit at a later date than for one who has not demonstrated fitness at time of issue.