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INDIVIDUAL LIFE PRODUCT DEVELOPMENT

Moderator: JAMES F. REISKYTL. Panelists: EDWARD T. HILL, MICHAEL L. SMITH, WILLIAM H. STRONG

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Policy Loan Rate Considerations

MR. WILLIAM H. STRONG: For many years, the 5% and 6% policy loan interest rates required on individual life insurance contracts have caused severe cash-flow problems for the companies, and also inequities among groups of policyholders, particularly between borrowers and non-borrowers. Fortunately, there has been a broad move among the states in recent years to permit the use of a fixed or variable 8% policy loan rate for new issues, until today only a handful of states remain at 6% for new business. There is reason to hope some or all of them may move to 8% in the near future.

This trend has been very encouraging, and will be extremely helpful to the industry in future years I believe, but it does not address the current problem of existing business that remains at the lower loan rates. This business represents the bulk of total loanable values at the present time and the cash-flow problems for companies and the inequity between borrowers and non-borrowers remain with respect to this business.

Most mutual companies maintain separate dividend scales for each loan rate. In several states, in fact, this has been required as a condition for approval to issue new business with an 8% loan rate. Separate dividend scales raise administrative costs and and leave a large part of the problem unsolved.

Many mutuals have considered, or are considering, implementation of amendment programs that would allow existing policyholders to elect to increase their loan rate to 8%, and thereby qualify for the higher dividend scale. Such a program might be limited to the the current or recent editions under which 8% policies have been issued, or it might be expanded to include all prior editions as well. Either approach presents practical and philosophical problems, ranging from an appropriate method of notifying eligible policyholders, to the philosophical problem of equitable treatment of those who stay at the lower rate. At the present time it is not clear whether every state that permits 8% for new issues will also approve an amendment program for existing business. In any event, it looks like the multi-scale problem will be with us for the foreseeable future since there will be significant numbers of policyholders electing to stay at the lower rate.

Longer range, I think there are two possible developments that might effectively reduce the proportions of our current "policy loan problem."

The first would be approval from the states to vary dividends for existing business according to loan activity as well as interest rate on a policy-by-policy basis, thereby restoring the policy loan provision to the "convenience facility" it was originally intended to be and eliminating the aspects of a financial leveraging device.

The second possibility, also requiring regulatory approval, would be the use of an adjustable life product utilizing a partial withdrawal privilege _in lieu of_ a policy loan provision. Amounts withdrawn would, of course, reduce the available cash values and they would also either reduce the immediate death benefit or period of coverage, or possibly increase future premiums, or extend the premium paying period. Presumably there would have to be some provision for future reinstatement of amounts withdrawn without evidence of insurability.

My view is that the traditional policy loan provision is a non-insurance benefit that should be incidental to the contract. However, in today's environment it has become a central part of the policy. In fact it has grown in importance so much that it affects buying decisions and disrupts equity among policyholder groups. I think we need to try to change the attitudes of regulators and the buying public concerning policy loans, and take upon ourselves the responsibility to find alternative ways for owners to tap policy values without terminating their coverage.

Federal Income Tax Considerations

MR. STRONG: As there have already been separate concurrent sessions and also workshops dealing with the impact of personal and business taxation on individual product design in the areas of split dollar and the developing market for Section 79 and retired life reserves, I am going to limit my comments to the impact of life insurance company taxation under the 1959 Act. Also since my day to day work doesn't bring me into contact with the technical aspects of taxation, I will limit my comments to some rather general remarks about pricing implications in the U.S., and look for some more penetrating observations in the follow-up discussion and also perhaps some indication of recent tax developments in Canada.

One of the more interesting developments in recent years, has been the increasing disparity in the federal income tax treatment of nonqualified policy reserves held on an ever broadening spectrum of valuation interest rates. This phenomenon is a reflection of the approximate nature of the Menge 10 for 1 rule built into the 1959 Act. For example, from the inception of the Act until two years ago, all the business of my company, The Connecticut Mutual, was valued at either 2½% or 3% and the difference in tax treatment between those two classes of business was not material. Early in 1976 we introduced a new policy series at 3½%, and earlier this year we introduced a Whole Life policy with 4% reserves. This progression is typical of an emerging industry trend, due in part to the Menge Rule, which produces more favorable results as the gap between the valuation rate and the adjusted reserve rate is narrowed. This trend, by itself, is not a problem. What is somewhat troubling is that the tax law provides an incentive to higher valuation rates for new business, and that we are no longer in the traditional environment where the choice of reserve basis was essentially independent of the ultimate profitability or performance of business issued.

Also of growing interest in recent years has been the relative tax position of net level reserves vis-a-vis CRVM or some other modified method with approximate 818(c) revaluation as provided in the code.

Studies at The Connecticut Mutual, based on our business, indicate that CRVM does provide some modest advantage at the young issue ages, but that this advantage shifts back to Net Level at the older ages, with the break point being somewhere in the neighborhood of 40 or 45, and that overall there is little difference between the two valuation methods from a tax standpoint. These conclusions will, however, vary somewhat among companies due to differences in the distribution of their business by plan and age.

In summary, it seems to me that federal income taxation is not only becoming more and more a factor to be recognized in product pricing and dividend determination--it has always been that--but it is in fact developing into a consideration that can influence fundamental decisions about product design through its impact on different reserve bases. This, in turn, imposes additional discipline and responsibility on the actuarial profession to maintain equitable treatment of different policyholder groups.

Inflation Recognition

MR. EDWARD T. HILL: Most of my comments will be on inflation recognition. There are two reasons for this. One reason is that I was invited to be on the program because of a particular product which our company has created and I am assuming that your main interest in my contribution is in connection with this product. The other reason is that at the present time I know very little about the other subjects. For about three years my work has been that of a marketing rather than an actuarial executive, and I am far from up to date on technical matters.

The individual--our customer--who, with the help of his life underwriter, is building his financial security program, has a right to be deeply concerned about the impact of inflation. Will they put together a program which includes life insurance products, as well as the other assets and benefits, which provides the needed amounts of death and retirement benefits in today's dollars or in terms of the actual costs of goods and services at the time the benefits are payable? John Bragg, in his presidential address to the Society in Toronto in 1976, made the following statement as one of five major points in connection with life insurance products of the future: "Products of the future will involve protection against the erosion of cash values and death benefits due to inflation. This also will be a slowly developing trend however." John Bragg lays emphasis on both the death protection and the cash value and I think our prospect should as well. I believe that the industry and the agent have some responsibility to help that client resolve this problem.

How has the industry tackled this question? What is available now? Perhaps the first thing we think of is the use of the dividend options. Accumulations provide some increases in proceeds at death or at an annuity conversion date. Paid-up additions provide a somewhat higher increase in death benefit and a somewhat lower value for annuity conversion, while the fifth dividend option goes still farther in that direction. In any of these cases, however, the improvement in benefit is not likely to be much more than a compounding of 2 or 2½%, not very consoling when we compare it to the 6% and 7% rates of increase in the Consumer Price Index that we are seeing today. Other new dividend options have been developed recently that provide death benefits tied more directly to the CPI.

A program of supplementing life insurance coverage by additional new purchases when the present level of coverage becomes too low by current standards, is perhaps the normal way to handle the problem. This can work reasonably well, although it can come to an abrupt end if the individual's insurability deteriorates, and the hit or miss pattern may turn out to be negligent and expensive.

Another common process is to buy considerably more insurance than is needed with the expectation that the cost of living will soon catch up. Again this is an expensive way of doing things, probably necessitating the use of mainly term insurance as permanent insurance may be too expensive for such a plan. A program of conversion might go along with this. Eventually if inflation continues such over-purchasing will also become inadequate and have to be supplemented by new purchases.

The industry has devised a few products to help meet these needs. The variable life insurance policies were presumably designed with this in mind, and will undoubtedly do at least a partial job, if only the value of equity funds which back these policies would move in a manner somewhat reflective of the value of the dollar. This, of course, has not happened for many years which leads me to dismiss these policies for this particular purpose.

There are also available increasing insurance policies, guaranteed insurability options, and some index-related policies, the latter being mainly Term or Term Rider types of policies but including some Whole Life policies. A paper by John Bragg included in a publication of the Wharton School in 1971 on the subject of variable life insurance, surveys the products then available. The product that I want to describe to you today is an Indexed Whole Life policy. North American Life introduced its Indexed Protection policy in both Canada and the United States in early 1969. This by the way, is the second unique Whole Life policy offered by this Company to the industry, the first being the Enhanced Protection product. This latter product was instantly recognized and imitated throughout the industry under such names as the Economatic, Extra Ordinary Life, etc., whereas the former has remained largely unnoticed.

Why is the Indexed Protection policy worthy of comment? Like its sister policy it mobilizes dividends to solve a particular problem. In this case the dividends are used to provide face amounts and cash values which increase in accordance with some standard index of inflation. Our company has elected to use the Consumer Price Index, although we provide in our policy that we could move to another index if we felt it to be more appropriate.

Here is how it works. Our Company does not pay dividends before the second year, so no indexing takes place before the second anniversary. Related to each anniversary there is specified an index, which is the CPI for the month four months prior to that anniversary. At each anniversary the face amount of the policy increases to an amount such that the ratio of that amount to the initially purchased amount is equal to the ratio of the associated index to the index associated with the first anniversary unless one of several limitations in the policy prevents it from reaching that level. When an increase occurs on an anniversary, it takes the form of a new, small Whole Life policy with the original issue age and the same structure of cash values, premiums and dividends as the basic policy to which it is added. The customer now has a policy which has the same premiums, same cash values, and same dividends per $1,000 but which has a new higher face amount. The cost of back-dating this increase is taken from the dividend fund at that time. The process of back-dating may be somewhat foreign to U.S. actuaries because of your remarkable state laws prohibiting back-dating, but it will be clear that a life insurance policy can easily be back-dated by simply charging back premiums plus interest less the cost of insurance or, perhaps more accurately, the asset share.

To repeat then, we simply increase the policy at each anniversary as dictated by changes in the CPI with each increase dated back to issue. The cost of this back-dating is deducted from dividend funds and the increased policy has the same premiums, cash values, and future dividends per $1,000 as before. Note that it is not just the face amount that moves in concert with the inflation index, but also the cash value which could eventually be the amount available for annuity conversion if the policy is used for this purpose at retirement.

Perhaps some of these features will appear problematical to you. You may wonder, for example, if the back-dating process is contrary to state law. We feel quite strongly that it is not, because the laws prohibit insurance from being dated before the date of the original application therefor--the original application for this policy was one which increases in line with the cost of living. You may also wonder about the acceptance of the increasing premium feature. This could be the first thing that would strike the person who is thinking about developing such a plan, and he would undoubtedly perceive it as a major negative. It must be kept in mind that this plan is intended for the person who wants to protect not only his face amount, but his cash value. It will not be hard to convince that person that to achieve the cash value which is payable in constant dollars, he will have to pay constant dollars. It is interesting that those of our representatives who have adopted this plan have also been able to portray this in a very positive manner. Proof of this is in our lapse experience. Purchases of these policies result from quite thorough interviews and the lapse rates are very low.

The cost of back-dating might appear to be a problem, but some very simple approximate calculations can be designed and the whole thing can be handled mechanically. The most important thing in this regard is to provide for first year commission on any increase in premium arising from inflation. After all, the representative has sold a policy which reduces the need for him to be going back from time to time to increase that policyholder's level of protection, and has therefore lost the opportunity to achieve first year commission from those repeat sales. First year commission on increases recompenses him for that and helps provide him with an inflation proof income as well. It also contributes to the high persistency rate experienced on these policies. You might be interested to know that one of our agents who has endorsed the plan said that he has sold enough of these policies, that when he wakes up on January 1 in any year he knows that before selling a single policy, he is going to make the MDRT on the increases on his Indexed Protection policies.

I mentioned earlier that we put limits on the amount of indexing that might occur. In fact, our current plan allows for a maximum annual increase of 6% of last year's face amount or 10% of the initial face amount, whichever is smaller. The limitation is necessary because dividend scales will not support increases that are too high relative to the basic policy. We also think that there is a need for a limitation to protect all parties to the contract, including ourselves, from becoming too frightened about the prospect of runaway inflation. While we think there is very little mortality anti-selection in this plan (and this is in stark contrast to an Indexed Yearly Renewable Term plan or rider which we also offer where we believe there is much opportunity for mortality anti-selection), we also think that modest and regular increases in the level of protection should help reduce any mortality anti-selection that may exist.

When this principle was introduced some years ago, it was applied to our regular Whole Life plan. This decision was not too good because it seems likely that, with the inflation experience that has occurred, there will be some age and duration combinations where dividend funds are insufficient to purchase the contractual increases. In this case, the policyholder has the option to either pay an additional premium to fund the amount which cannot be purchased by the dividend, or to accept the lower increase. We have since developed a special Whole Life plan with somewhat higher premiums and dividends so that, based on the current dividend scale and the maximum increase limits permitted under the policy, this situation cannot occur.

An indexed waiver of premium feature providing for the continuation of indexing even though a policyholder may be disabled may be added to the plan. An indexed payor benefit (waiver of the indexed premium upon death of the payor) is also available for juvenile policies.

Our Indexed Yearly Renewable Term policies and riders are very simply constructed and the elegant back-dating concept is unnecessary. The main problem is mortality anti-selection. The premiums cannot be very much higher than regular YRT premiums, else healthy policyholders will lapse their policies in favor of purchasing new lower priced non-indexing policies, while the unhealthy policyholders will, of course, continue and increase their coverage. Careful limitations and premium determination, with perhaps a maximum level of indexing or a maximum indexing period, may be necessary.

Interest Rate Considerations For Nonforfeiture Values And Reserves

MR. HILL: I mentioned earlier that I have had little to do with our United States division or with actuarial work for some years. Therefore, I am totally unqualified, I guess, to comment on some of the remaining items. I have however, some brief comments which are my own simplifications, perhaps oversimplifications, of some suggestions made to me by two actuaries in our U.S. product development area. They are to be thought of as relating to U.S. products from the point of view of a Canadian mutual company operating in both countries whose main marketing thrust is and has been based on low go-in premiums.

With respect to permanent participating policies, there appear to be two basic considerations in the selection of an interest rate for nonforfeiture values and reserves:

1. Desired characteristics of the ultimate product.

2. Tax effect of the valuation interest rate.

In any specific product, one of the major structural elements (i.e. gross premiums, dividends or cash values) may be stressed more than the others, while the others are constrained to vary within a pre-determined acceptable range, such range being based on marketing considerations. The type of plan--deferred compensation, Section 79, high early cash value, special dividend usage, etc.--will determine which structural element is to receive the most attention.

If a high early cash value product is being developed, a low interest rate may be needed. The formula used may also provide some variation in the level of cash values. If the key element of the product being developed is a low gross premium, it would be desirable to guarantee as high an interest rate as possible from the point of view of an appropriate actuarial long-term guarantee, and then keep the nonforfeiture value per $1,000 low relative to the gross premium, thus minimizing losses due to lapses and policy loans. It appears that the trend toward nonforfeiture value interest rates of 4% has developed for these reasons.

At present the reserve interest rate follows directly from the cash value interest rate because the 1976 NAIC Model Law delinking these rates has not been adopted in enough states to be useful.

The effect which the level of interest rates chosen has on the company's income tax position must be carefully examined. As I mentioned we are talking about United States products offered by a Canadian mutual company operating in both countries, and it can only be said that the results of interest rate choices in the two areas and the resultant interaction is extremely difficult to evaluate. I will not attempt to make specific comments on tax implications. I would point out, however, that in Canada reserves for tax purposes are currently being re-examined by the authorities with a regulation expected any day. This together with the complications of the secretary's ratio tax produces an unenviable situation for the Canadian product developer at this particular point of time. You may be aware that a Canadian company is taxed as though its assets were approximately 115% of liability, the 15% being the so-called secretary's ratio. Even if your assets are less than that, a tax is paid on income imputed to that inflated level of assets.

MR. MICHAEL L. SMITH: From our experience, the foremost consideration in life insurance permanent product development is consideration of the market we desire to reach, and for which the product is being developed, such as keyman, split dollar, buy-sell, deferred compensation, personal, etc. Drawing upon past experience the initial direct emphasis will usually, but not always, be upon the pattern and level of cash values that the target market will find most appealing. Premium level, relative cost comparison position, and competition are certainly not given a backseat, but, more often than not, we initially turn to nonforfeiture values once the development rolls into our actuarial phase.

Usually for us the choice of an interest rate--and thus the level of the values--is more or less secondary to the pattern of values. Business insurance implies high early cash values, such as greater than minimum values with no more than 3% interest, whereas low premium permanent would suggest minimum values with the maximum permissible nonforfeiture interest rate. The maximum permissible rate for individual life plans is now 4% in practically all states. The possibility of using a higher rate in some states currently exists, and most probably in the future we'll be seeing more states adopting the 1976 NAIC Task Force recommended maximum of 5½% interest for annual premium life insurance. Thus the range of choice of interest rates may now be greater, and certainly regulatory permissiveness cannot be overlooked.

Primarily due to the limited amount of time generally available to us when pricing a product, we have never seriously considered using "dual" interest rates. From my review of products available in the industry, I don't believe the industry has given more than a passing glance to the use of more than one interest rate either. A grading method such as minimum to net level is probably more practical and effective in accomplishing the end result, considering all factors.

While the emphasis has been on cash values for the most part, the level of the other nonforfeiture values should be considered. It was somewhat surprising to note our own field force strongly emphasizing the favorable paid-up values under our low premium 4% cash value plan, which was released slightly more than a year ago. Per dollar of total premiums, the 4% cash value contract offers 13¢ to 25¢ more in reduced paid-up value at age 65 than our 3% contracts.

Maintenance expenses are subject to inflationary pressures and clearly the expense margins available for policies with the higher interest rate nonforfeiture options are not as great as under the lower interest rate nonforfeiture options.

All that be as it may, an argument could be made for first determining the interest rate for reserve purposes and then, because of the link between the nonforfeiture and valuation laws, the nonforfeiture interest rate would follow. In our shop, however, it's vice versa.

We have heard there is a tax effect of the valuation interest rate, and also the valuation method. I would like to comment, however, on a particular problem which we do not dismiss in our permanent product development, and which may not be as pressing for us as it might be for other stock companies, and that is deficiency reserves.

Our experience has been that the higher nonforfeiture interest rate will compound any deficiency reserve problem. Under our 3% cash value contract we have concerns and with a 4% contract we have greater concerns. Although the regulatory concern for financial solvency may readily support the deficiency reserve philosophy, in my own mind the required existence of such has contributed unnecessarily to increasing the cost of life insurance for some people. Our surplus position has prevented this issue from becoming more than just a nuisance, but I am satisfied that that is not the case for other financially sound non-par companies.

Reserve Valuation Methods

MR. HILL: I have a short comment on reserve valuation methods. The method should have no impact on product development. Ideally a product should be developed and then a reserve valuation method should be devised which, in line with company goals, makes proper provision for liabilities, development of surplus, and deferral of expenses. It seems unfortunate that the valuation method should be so tied to the policy structure that important tax effects can depend on this choice, the tax impact of which, as mentioned in connection with interest rates, is very complicated to determine for the kind of company I am associated with.

Innovations In Asset Share Techniques Or In Other Rate-Value-Dividend Methods

MR. SMITH: Since I find myself still struggling with traditional approaches and principles of the asset share technique, I do not have a lot to offer on the subject of innovative asset share techniques. Being of a non-par background, I also suffer from lacking the more rigorous sophistication required by the presence and treatment of dividends. A few topics, however, should be mentioned.

Our own asset share techniques do not specifically incorporate a direct assumption for federal income taxes. In other words, our assumptions are primarily pre-federal income tax and the assumptions as to specific margins for profit must cover these taxes. Since there are greater federal income tax implications arising from higher investment returns, the degree of confidence in this armchair approach can suffer. An alternative is to attempt to incorporate the valuation method and interest rate, even to the degree of converting from a calendar year tax treatment to policy year, within the asset share technique. We have tried to do something along these lines, but the results have not been particularly satisfying.

Asset shares for multiple life variations of the joint life status--including the last survivor of the joint life status--require innovative techniques. Joint life equal age functions can be developed into a fairly simplified set of traditional single life functions and then such single life functions can be used in the normal manner for asset share calculation purposes. Equivalent age determinations of joint life functions of, say, the 1965-1970 Select and Ultimate Basic Table or whatever pricing basis you may use, would appear to necessitate approximate practical measures or else the calculation would appear to be unduly complex.

We have attempted to develop an approach to estimate the adverse mortality which will probably be experienced on annually renewable term policies. One practical approach is to test the premium rates against several different mortality levels and patterns. A more complex approach which we attempted, was to determine the percentage increase in mortality by assuming the withdrawals or lapses would qualify for standard insurance at their attained ages. This approach appears to have some merit, since those lapsing probably do so to obtain the better rates available to new issues. Under this approach we found that the percentage increases increased step-wise during the early policy years and then remained relatively level.

Another facet which I hope we can eventually pursue is a better matching of asset share cash flows with varying investment medium blends and philosophies -- such as asset losses, capital gains taxes and policy loan patterns. Inflationary expenses have been indirectly handled on a basis somewhat like our approach to federal income taxes whereas a more direct assumption, such as by policy duration, might be more meaningful.

State Approvals (And Disapprovals)

MR. SMITH: Products utilizing a 4% nonforfeiture value interest rate are receiving approval in virtually every jurisdiction in the 50 states with the exception of Alaska, the District of Columbia, and Maryland. I understand some promising efforts are underway in the District of Columbia. Maryland has legislation awaiting the governor's signature which will permit the commissioner, as of July 1 of this year, to authorize a rate in excess of 3½% but not in excess of 4% per annum, upon a finding that such action will reduce the net cost of life insurance offered by the company in direct relationship to the revenue from such increase. Our submission to the department of a 4% cash value contract has been returned with the requirement that we furnish the necessary documentation to justify that action.

I understand that similar legislation in Maryland also covers policy loan interest rates in excess of 6% where the requirement of the finding of a reduction in the net cost of life insurance might be somewhat more appropriate.

We have not gone to an 8% policy loan interest rate on our non-par contracts. My own investigations indicate that among stock companies we are not alone in this regard. I understand that some companies have undergone a recent filing experience with 8% policy loan interest rate contract forms and the state filing problems appear to be no more difficult than otherwise. It is reported that a few states will require justification of the policyholder benefiting from such action.

Much has been kicked around regarding deposit term and deposit whole life policies. State actions range from complete prohibition, to special minimum nonforfeiture values, to completion of disclosure statements. The essential effect of the special minimum nonforfeiture values is to create cash values as early as the fifth policy year and perhaps as early as the third year for older ages. Interestingly enough, for deposit whole life type plans, the special minimum value requirements lead to some inappropriate results, such as values exceeding net level reserves at later policy durations.

Recently legislation has also been directed to the graded death benefit plans. These plans provide payment of the face amount only in the event of death due to other than natural causes in the early policy years. The rationale leading to the prohibition of such contracts is that they are not life insurance contracts, and thus may be misleading. In lieu of prohibition, contracts which provide coverage of minimum multiples of the premiums paid during the early policy years are acceptable. This causes a conflict for graded death benefit plans offered to substandard risks (who essentially pay a standard premium for reduced death benefits).

Joint life contracts have been around for some time. A recent innovation is the Last Survivor Whole Life or Survivorship Whole Life type policy. Here the death benefit is payable upon the death of the last to die. Normally for these contracts, nonforfeiture value requirements are extended to require values for each of the possible multiple life situations, e.g. for a two life contract, there is one set of cash values to be used when both insureds are alive, and two other sets for use depending upon which insured is alive.

A modification of this concept which has met approval in some states, determines the cash values around the last survivor. In other words, probabilities of survivorship are developed for the last survivor, of the last survivor status of two equal ages. This approach lends itself rather nicely to traditional single life formulas. There is then only one cash value and the normal reduced paid-up and extended term options.

Contingent life is another modification of the joint life status which apportions values among the individual lives and the joint multiple life status. This particular product has not met with approval in all states.

Disclosure

MR. STRONG: I assume everyone is generally familiar with the provisions of the NAIC model disclosure legislation which requires, with respect to all new policies delivered, that interest-adjusted information about that policy be provided at the point of sale and that those calculations assume a 5% interest rate to measure the time value of money. This model legislation has to date only been enacted in a handful of states, but it is clear that the number of states providing for that legislation will grow in the next several years. At The Connecticut Mutual, we have implemented all the provisions of the NAIC model disclosure regulation nationwide. Each policy that is delivered is accompanied by a policy summary containing the required interest-adjusted information, and we also supplement all our traditional ledger type illustrations with the interest-adjusted information.

The Federal Trade Commission, in its ongoing examination of sales practices, has also indicated that they have a strong interest in the area of disclosure to policyholders. A target date for their final conclusions has not been established, so there is no way, at this point, of really knowing what their findings will be in this area. They clearly are leaning away from the NAIC interest-adjusted version and appear to be leaning toward a Belth-type annual cost of protection version. This method does overcome one of the significant drawbacks of the interest-adjusted method, in that it takes the amount at risk directly into account, year by year. However, it has a disadvantage in that it does not lend itself well to measuring costs of protection over a period of years. The FTC may end up developing their own method, and attempt to require its use.

There is another aspect of disclosure which I think is becoming increasingly important to us, particularly those of us with mutual companies, and that is disclosure after the policy is in force. I am referring to the growing perception among policyholders of their right to information concerning their coverage and particularly in mutual companies with respect to the calculation of their annual dividends. At The Connecticut Mutual we attach high priority to requests of this nature. All such requests are referred from our Policyholder Services Division to me or to another one of our product actuaries or actuarial students. We attempt to provide as meaningful an explanation as we can. We generally try to handle the first request with a form letter that goes about 15% to 20% of the way into the nitty gritty. If more clarification is requested, we will provide it even to the point of duplicating the dividend calculation virtually from first principals. I think this area of disclosure will become more and more troublesome and significant to us and that interest in it, both among both regulators and consumers, will continue to grow. That, of course, will mean more work for the agents and the home office. Yet in the final analysis, I think this disclosure trend is a positive force for our industry because in the long run I believe it will improve our credibility with the buying public and also it will, I hope, result in better buying decisions.

Deposit Term Or Term Plus Annuities

MR. SMITH: Within the last several years we have seen an increasing growth of low premium term plans and usually these are accompanied by either deposit fund riders or annuities. In a number of current situations, we find that the term rates themselves are not necessarily attractive, but the projection of total death benefits (term insurance plus the amount in either the deposit fund or the annuity) and the total but not guaranteed cash surrender values are very enticing to the inflation wary prospect as a possible alternative to the fixed death benefit of traditional level premium Whole Life. Normally the term plan and annuity are separable pieces and thus we assume that each is self-supporting.

The pressures for buying term and investing the difference are probably at their zenith because available investment returns are at historically high levels and there is an ever increasing awareness from the insurance buying public of the corrosive effect inflation is having upon fixed dollar benefits.

The demarcation between banking or investment functions and the deposit aspects of these life insurance products, is not as discernible as it was ten or even five years ago. Concern over the implications of providing long term guarantees and little protection against asset deterioration in the event of early withdrawal without penalty, has led some states to impose restrictions on deposit fund arrangements.

Primarily these restrictions are directed to the amount which may be deposited in any one year, such as twice the annual premium required for the policy; or the maximum amount of funds which the insuring company may hold, such as the smaller of (a) the total amount of the next ten annual premiums and (b) the difference between the face amount and the cash value of the life policy. Restrictions may also exist as to the illustration and projection of values on the basis of interest credits in excess of those guaranteed. Guaranteed rates are usually restricted to not exceed the maximum permitted by the jurisdiction's maximum permissible interest rate for the valuation of deferred annuity contracts. Additional reserves for guaranteed rates in excess of the maximum permissible valuation rate are also normally required. Other requirements may include disclosure statements depicting a summary of contract benefits and an illustration of values under guaranteed interest credits.

Our review of some of the term insurance plus deposit fund or annuity combinations indicates projections on the basis of relatively high current interest rates and usually on a pre-federal income tax basis. Our tax people feel that there is a legitimate concern as to whether such interest credits might qualify, on the company's part, either as an interest paid deduction, or as a deduction for required interest to maintain life reserves. Naturally the response to that concern has considerable impact upon the development of such products. It's also felt that the policyholder is subject to reporting all or a portion of such interest credits as taxable income. Under such conditions an after tax illustration of term insurance plus deposit funds or annuity combinations is not as appealing.

What is the compelling force behind the continuing lowering of term rates--especially annually renewable term premiums? Appropriately, I should direct that question to our own situation since our term reductions were significant in 1973 and we managed to do it again in 1977. Competition is intense--there is no doubt about that--and certainly the consumer's tendency now is to seek as much protection as possible for the dollar outlay. We feel that we are not at the point of having our term rates subsidized by our permanent products, but that point may not be very far away for us. We feel very strongly that term insurance is a valuable commodity and shouldn't be cheapened by give away prices.

The deficiency reserve requirements of some states view the term policy as a contract with premiums payable to the expiry age. Thus all the premiums payable under the contract must be compared with all valuation premiums in renewal years. Normally, excesses are not permitted to offset deficiencies. Very low initial term premiums may produce sizable deficiency reserves and even reinsurers are not apt to participate in such on term coinsurance offers. Use of a more modern mortality table offers some alleviation. Another tactic to reduce sizable reserves may be to increase the rate levels at the very old ages.

Contingent Life

MR. SMITH: Contingent Life is a permanent life product covering multiple life situations. It has been advocated for stock redemption, keyman coverage, buy-sell arrangements, non-qualified deferred compensation, family financial and/or estate planning, and combinations of business and personal insurance under one plan.

If I might corrupt the product to basic essentials for purposes of brevity, the product is a modification of a joint life policy. Instead of providing one level premium and one set of cash values, the product is actually a set of individual permanent life policies. Each provides for a level premium, and each has a unique set of cash values. The sum of the individual policy premiums and the sum of the individual policy cash values total to the premium and cash values, respectively, for the joint multiple life status. Each individual policy has its own policyowner, beneficiary, assignment provisions, nonforfeiture options, etc. Upon the death of an insured all the policies on the survivors immediately terminate. The cash value of each policy is paid to each respective policyowner. New individual policies of a new contingent life plan on the survivors (with a right of refusal) at their then attained ages are immediately issued with the first premium paid from the proceeds. The balance of the proceeds, i.e. the face amount less the sum of the individual policy cash values paid and less the first premium paid for the new individual policies, is paid to the beneficiary of the deceased insured. Conversion options are also guaranteed in the event an insured life exits from the plan.

By covering the next death, (not just the first death, since coverage is continued to become payable in the event of the next death and the next), the product is able to offer decisive premium and cash value advantages as opposed to traditional Whole Life premiums and cash values on each life.

Though the product also overcomes some of the disadvantages of the joint life policy form covering multiple lives, the product is inherently more expensive to administer than an equal number of whole life policies due to the "re-issue" situation when a life leaves the plan. Computerized administration is virtually mandated since joint equivalent ages must be determined for each particular insured group of lives. Considerable sales illustration and proposal report systems must be employed and the product has not yet been approved in all states.

In our company and I believe most others, we tend to approach new product development with the thought that an acceptable sales volume should be generated to justify or offset start-up and unusal administrative expenses. This factor plus the others that I've mentioned have probably been reasons why Contingent Life has not been pursued with more enthusiasm by more companies.

MR. STRONG: We do not offer Contingent Life, but have been interested in it for some time. As Mike mentioned, Contingent Life provides a separate contract for each insured and policy values are apportioned among individual participants. These features make it convenient for individuals to leave or join the insured group without disrupting the plan. Because of this fleixiblity, Contingent Life would seem to be especially appropriate for business insurance sales. Administrative complications and other priorities have prevented us from pursuing this one more actively.

Joint Life

MR. STRONG: My company, The Connecticut Mutual, has had a two-life Joint Life product for many years, but until 1976 we handled that product very much on an exception basis. We didn't promote it with our field; we didn't have the capability to illustrate it on a computerized basis; no premiums or values appeared in our rate book; and we even had a good deal of difficulty issuing a policy.

In 1976 we enhanced our Joint Life product by extending its availability up to five lives. We included it in our computerized illustration service and promoted it with the field. We made these moves in recognition of the growing trend toward two income families, and we also saw marketing opportunities in partnership situations, multi-key-person coverage and in other business and personal insurance situations. Our Joint Life product can vary the mix of coverage on insured individuals through level or decreasing single life term riders; it provides full insurability for the survivor at the first death or for all survivors at the first death and can be exchanged for single life policies on the separate insureds on any policy anniversary. In short, we have tried to build in the flexibility to accommodate changing needs and changing financial relationships.

Sales results so far, while not overwhelming, have met our expectations. Last year we sold $14,000,000 of Joint Life face amount at the rate of about 50 policies a month. The average size policy was about $25,000 compared with $35,000 for our nonpension business generally, but we did not expect the kind of jumbo sales that we get from our Whole Life and other nonpension products. Our agents frequently find Joint Life helpful to have "on the shelf" and, given the marginal cost of developing and maintaining the plan, we are happy to have it available within our portfolio and will be looking for increased sales in the years ahead.

On March 1st of this year The Connecticut Mutual introduced a second-death joint life policy, which we call Survivor Joint Life. This contract is available only on two lives and becomes fully paid-up at the death of the first insured. We found that the provision of becoming paid-up at the first death simplified a number of actuarial and administrative problems for us, as well as providing some marketing advantages. The product was targeted specifically for estate-planning applications for married couples with anticipated estates up to about one-half million dollars. We also foresee possible application in partnership or multi-key-person situations where the business could sustain the loss of one individual but not both. An attractive feature of this plan is the low level of gross premiums relative to two whole life policies, especially if either insured is substandard. At the present time the only rider available is the waiver of premium rider. We will consider in the coming months and years whether we want to make any other riders available. Survivor Joint Life has been available for only 10 weeks now, so it is too early to evaluate the sales results.

A joint life product which we do not offer but which has created field interest, particularly in the last six months, is Joint Decreasing Term. Presumably the demand for this product will grow with the growth of the two income families.

I have felt for some time that joint life insurance products of various forms should be coming into their own because of the economy they offer where there is a financial relationship or interdependence among insured individuals. To date, this market has not developed as rapidly as I thought it might. Perhaps we need to do a better job of communicating the advantages of joint coverage to agents and to the buying public, and try to build even more flexibility into our products. Buying and selling habits change slowly, but I am convinced that the basic idea of joint insurance is sound and marketable.

Questions And Answers

MR. LARRY E. THOEN: Mr. Hill, are the indexed face amount increases automatic or does the insured have the option to accept or decline the increase each year?

MR. HILL: It's an automatic feature; the policyholder receives a notice of the amount of increased face amount, a notice of the index, and he is billed for the increased premium. He has the right to opt out at any stage of the game; if he opts out, that is the end of it. I don't think we've ever had anyone opt out.

MR. THOMAS S. FERGUSON, JR.: Mr. Hill, could you comment on the sales results that you're getting with your indexed whole life policy?

MR. HILL: We introduced the product in 1969 in both Canada and the United States. In the United States right from the beginning there were a handful of agents who saw its possibilities. Approximately 10% of total first year commissions paid in the United States each year since 1969 has been paid for indexing policies, exclusive of the commissions paid on indexed increases. In Canada we had a much lower acceptance rate for the early period, but when we re-introduced it in the fall of 1976 it took off and we currently are paying about 15% of our first year commissions on indexed policies.

MR. STEVEN A. SMITH: I would like to comment on our Contingent Life sales experience at First Colony Life. In 1977, our average premium per Contingent Life case was around $4,500 and the average face amount was about $75,000. Total sales were about $750,000 of premium. Three-quarters of a million of premium perhaps is not a lot for some companies, but it represented about 8% of our new premium. The average size of $75,000 was probably due to the fact that most of it was sold in the business market and that we have a minimum size of $50,000, except for two-life cases which have a minimum size of $25,000.

I also have two questions. Mr. Hill, what arrangements do you have for reinsurance on your Indexed Protection policy? If for example you have a $100,000 retention limit what is your procedure for reinsuring increases on a $100,000 policy? The second question is for anyone. In the last couple of months at First Colony we have received some "form type" letters from policyholders who bought yearly renewable term policies seven or eight years ago and somehow found out that we have reduced our rates a couple of times since then. They ask for reduced rates for renewals on their YRT policies and for a rebate of all monies that we overcharged them for past experience. Has anyone received this kind of inquiry and if so how did you respond? Does a company have any obligation or duty, legal or otherwise, to disclose these rate reductions to existing YRT policyholders? If you have to lower premiums, that would have serious pricing and sales implications, of course. Those are the two questions, first reinsurance on the indexed protection and then the YRT rate disclosure question.

MR. HILL: We have an exclusion in our bylaws covering retention for such things as indexing, paid-up additions, etc. so that no policy that is within our retention at the time of issue will go over our retention limit by virtue of indexing or by virtue of paid-up additions. We reinsure policies which are initially above our level of retention and have had no trouble in finding reinsurers who are willing to coinsure the Indexed Protection policy. So reinsurance has not been a problem.

In response to your other question, we have had since 1966 what we call an augmentation program. If term premiums are reduced, we increase the amount of insurance on existing renewable term policies on a broad base to something more or less comparable to what their premiums would buy on the new rate basis. On a 5 year renewable term policy the increase occurs on the next quinquennial anniversary; YRT coverage increases on the next anniversary. Thus the benefit of our improved rates is made available to existing policyholders on an average basis, through increases in coverage rather than reductions in premiums. The first time we did this I believe we increased everyone's coverage by 25%. We prefer to increase coverage rather than to make premium reductions; we think the latter is inappropriate. Coverage augmentation is not guaranteed and no provision for it is built into the premium, but being a mutual company we feel that it is highly appropriate if not essential to have some kind of program. These are not <u>par</u> policies but we do this anyway and we think that everybody should.

MR. JAMES F. REISKYTL: Mr. Hill, there are a number of companies who currently are offering a reversion or rewrite privilege on yearly renewable term policies. At the end of some period, such as 5 or 10 years, if the insured presents evidence of insurability, he obtains a lower rate. You mentioned last night that your company offers this feature. Would you care to describe and comment on this feature?

MR. HILL: We introduced such a product in 1972. As I mentioned before our main marketing thrust is low go-in premiums and we were getting to the point where we simply could not compete with some of the other low go-in companies on regular YRT type policies with one rate for each age. So, we followed the lead of a number of companies--the one that I can recall that we looked at was Canada Life. We came up with a policy with two sets of premiums (Canada Life has three). One set of premiums is used for the first ten years of the policy. After 10 years a higher set of premiums based on attained age applies unless the policyowner submits evidence of insurability indicating that he is still a select life. The first set of premiums is based on select mortality; the second set is based on rates somewhat in excess of ultimate mortality.

Our indexed renewable term policy employs the same basic structure. The premiums are slightly higher than the premiums for the yearly renewable term policy. At the end of the tenth year, if the insured does not submit evidence indicating that he is still a select life, he goes into the higher level of premiums and future coverage is not indexed. If he produces satisfactory evidence, he remains in the lower level of premiums and continues to index.

MR. REISKYTL: How do you establish rates for those who do not meet the select standards?

MR. HILL: We do not have any experience data yet, but we expect the rates to be rather high.

MR. STRONG: Is a provision for that kind of re-underwriting program specifically indicated in the contract?

MR. HILL: Yes, and we intend to make it well known. It is well known among the agents. We advise the agent when an insured is approaching his tenth anniversary. We pay an additional commission if re-underwriting is successful.

MR. JESSE M. SCHWARTZ: I have two questions relating to indexed protection. Mr. Hill, why did you choose to back-date, rather than use attained age Whole Life with dividends applied to reduce the increased premium? Secondly, I was wondering if anyone else in the audience or on the panel would care to comment on their experience on election rates for indexing provisions.

MR. HILL: Gentlemen and ladies to me the use of the back-dating process is the beauty of the whole thing. It is such an elegant process. At any point in time there are no problems with displaying cash values or any other feature of the policy. When you wish to look up the cash value, all you have to know is the face amount of the policy. You don't have to go through elaborate cash value calculations. It is all right there. That is why we did it that way. It is an elegant concept. The other possible method involving an attained age premium and a set of cash values for the new attained age each time an indexing occurs would in my opinion, be an administrative horror. It would be confusing to policyholders, confusing to the field, and confusing to everybody. I wouldn't be agreeable to issuing that type of policy.

MR. REISKYTL: Does anyone selling indexed coverage wish to comment on their election rate experience?

MR. THOEN: We don't have an indexing policy per se at Minnesota Mutual but we do issue an adjustable life policy which has a cost of living rider. The rider is essentially an automatic insurability option, with option dates every third year. The increases are tied to the CPI index, subject to a 20% maximum face amount increase. Our election rate has been fairly high, about 70 to 75%. We have been issuing the policy since 1971.

MR. WALTER N. MILLER: I think the only way you will find to really get your field force educated and motivated to sell a joint life policy would be to pay a commission on it equal to that on your typical life plan. My question has to do with nonsmokers and/or preferred risk discounts. Do the panel members think that this is something that will be prevalent in the industry five or ten years hence?

MR. STRONG: Since The Connecticut Mutual just came out with preferred risk rates on March 1st of this year, it's obvious that we believe they will be. I think preferred risk rating is an important development. It enables us to improve the accuracy of our classification and pricing, and it reinforces an awareness of good health habits. Those are the two primary reasons why we decided to offer it.

MR. M. SMITH: It is said that what's good for the goose must be good for the gander so if everyone else is going that way then I guess we should take a look at it.

MR. MILLER: Mr. Strong, it is my understanding that your minimum size for preferred risk is $100,000. What is your justification for such a large minimum size?

MR. STRONG: The basic reason, Walt, is that we sell nonmedical up to $50,000, and only on policies of $100,000 and over can we really afford to develop the kind of information and tests that we feel are required for a meaningful risk identification. Secondarily it is our feeling that limiting the preferred risk class to policies of $100,000 and over insulates our standard class somewhat from the effect of the better risks leaving it. But the primary motivation is that we need to be able to financially justify the kinds of tests and information that we feel we need.

MR. REISKYTL: Mike, another development that you mentioned earlier is the payment of excess interest on non-par contracts. How have the state insurance departments reacted to this innovation?

MR. M. SMITH: Currently some companies are offering essentially non-par products with excess interest earnings, the excess being interest credits in excess of that guaranteed. These products are primarily deposit fund riders, but I have seen just this week a product called Excess Interest Whole Life. Apparently this product credits interest in excess of the guaranteed 4% rate and the excess interest becomes a permanent part of the cash value. I wonder how these policies can be called non-par. I think some of the regulators may be having problems with that also.

MR. REISKYTL: Bill, time pressures limited the opportunity for you and the other panelists to comment on each other's topics. I know you have given some thought to the impact of inflation on our products.

MR. STRONG: I would like to comment on two specific areas: (1) our opportunity and responsibility as an industry to provide for growing life insurance needs with our existing "traditional" products, and

(2) the possibility of a more complete response to inflation through some "non-traditional" product ideas that have surfaced in recent years.

(1) Most of us would probably agree that the general public is chronically underinsured, partly because of a general unawareness of the total insurance need in an inflationary environment, and partly because of an unwillingness or inability to pay for the additional coverage required even where the need is recognized.

As an industry we have responded, and should continue to respond, to this part of the problem with an increasing emphasis on the agent-client relationship and on personalized counseling and service; with more usable product illustrations, presenting the insurance need as part of an overall financial plan; and with certain fundamental changes in product design intended to maximize the protection purchased and value delivered for each dollar of premium outlay.

Let me take a few minutes to review with you some trends in product development at my company, that reflect these thoughts. We introduced a new policy series early in 1976 that featured significantly reduced premium levels for permanent insurance and a greatly improved net payment position. At the same time, we reduced substandard extra premiums through an elimination of commissions on the extra, together with a trimming of margin requirements. We also enhanced our term portfolio, making the decision to pay a full 50% first-year commission and thus provide agent enouragement for the term sale where that seemed appropriate.

The results of these changes were immediate and dramatic. Not only did our new business increase sharply as measured by premium or face amount; but our average policy size also jumped from about $25,000 to $35,000, bearing out our conviction that the critical factor in many life insurance sales is the ability to pay, and that a contract that delivers the right balance of competitive premiums and good long-term payments and costs will improve the sales volume, and premium income as well.

In recent months, as I mentioned earlier, we have reinforced and extended our philosophy by introducing a new whole life plan with 4% reserves and about 5% lower premiums, and a preferred risk underwriting class that can provide an additional 5% premium reduction on average to those who qualify.

Over the past two years, we have been increasingly satisfied with the direction we have taken. Many other companies, of course, are moving in the same direction, either on a selective plan-by-plan basis, or occasionally across their portfolio. This is, I believe, a positive trend in the battle against inflation.

(2) In longer-range terms, it is clear that some non-traditional concepts will be needed. Two such ideas have been around for a while now, Variable Life and indexed "Life-Cycle" products. I think interest in these has waned in recent years because of regulatory and administrative problems, and because of some real questions about the ability of these products to deal effectively with the impact

of inflation. I believe that, for most companies, sales of these products have been below expectations--Ted's Indexed Protection policy is apparently an exception--and this no doubt has contributed to a declining interest within the industry.

There is another idea of more recent origin, however. Adjustable Life is a product that may hold more promise than anything we have seen so far. An Adjustable Life policy issued with a Guaranteed Insurability Rider and an Automatic Increase Option would seem to provide the flexibility to adapt to changing circumstances and to counter, to at least some degree, the effects of inflation. At the Connecticut Mutual, we're very carefully evaluating the potential for Adjustable Life. We are hopeful that it will ultimately solve many of the problems of inflation, or at least reduce them to more manageable proportions. We see a particularly useful immediate application for this product in the Individual Pension Trust area, as a means of easing the multiple policy problem.

I might add that, even in the context of our existing products, the Guaranteed Insurability Rider is receiving increasing attention at the Connecticut Mutual as a means of dealing with the problem of inflation as it affects individual needs. We've increased the option amounts, liberalized contract provisions, and extended these benefits to existing policyholders by practice. Most recently, we've introduced a Future Insurability Rider for term plans that provides insurability upon conversion to a permanent plan within five years.

In summary, my feeling is that we should keep looking for things that can be done in the present product environment while we're seeking a longer-range solution.