RECORD OF SOCIETY OF ACTUARIES
1978 VOL. 4 NO. 2

ADJUSTABLE LIFE PRODUCTS

Moderator: ROBERT D. HOUGE. Panelists: JAMES C. CHARLING, J. STANLEY HILL, WILFRED A. KRAEGEL, ROBERT L. SENKLER

1. Problems encountered in the planning, development, implementation and maintenance stages of Adjustable Life Products.

2. *Topical areas:*
   a. product-design features
   b. strengths and limitations
   c. administrative systems and procedures
   d. actuarial-pricing
   e. nonforfeiture values and reserves
   f. marketing-agent's compensation
   g. sales results

MR. ROBERT D. HOGUE: In discussing Adjustable Life Products this morning, we will key in on the Chapin design. The design was described by Walter Chapin in a paper published in the 1975 transactions called Towards Adjustable Life Policies.

Mr. Chapin described a permanent individual life insurance policy whose premium, face amount and plan structures could be changed throughout the life of the policy. Keeping those three elements of the plan design in balance is a complicated set of mathematical formula which defines a plan with a set of cash values and reserves meeting the standard non-forfeiture and valuation regulations. In operation, the Adjustable Life Policy's change provisions provide virtually unlimited premium, face amount and plan change flexibility on a continuous basis over the lifetime of the policyholder.

We have structured the formal presentation portion of this session around the consideration of Adjustable Life by the management team of the Hypothetical Life Insurance Company. Each panelist will address the subject from a different perspective, depending on these assumed management roles:

Jim Charling - Chief Marketing Officer
Wil Kraegel - Chief Actuary
Bob Senkler - Chief Administrative Officer
Stan Hill - Chief Data Processing Officer

The Hypothetical Life is a medium size stock life company with about 2 billion dollars of individual life inforce. It is a New York company with a career agency distribution force of about 200 agents. It also has a brokerage operation with about 500 under contract. About 20% of its business comes from this outlet. Its primary market is the family market, but it also operates in the business market, the estate planning area, and the small pension plan area. About 20% of its business comes from these advanced underwriting areas. The internal administrative system is centered around a standard consolidated function daily cycle processing system. The Hypothetical Life has a solid financial base and has the capacity to finance large development projects.

As President, I must provide a sense of direction to our Adjustable Life considerations, however, I have mixed feelings on it. The concept seems simple, but the development would be complex and expensive. In addition the benefits appear to be long-range; I can see few short-range benefits to measure against the implementation cost. If we develop and release Adjustable Life, we will be deviating from our traditional fixed plan structure. Our computer, administrative, compensation and other processing systems are built around the structure. Adjustable Life will create a lot of problems and the need for a tremendous amount of change. Given the ramifications of an Adjustable Life decision, I have asked for the management team's comments.

MR. JAMES C. CHARLING: My comments as Chief Marketing Officer attempt to look at several issues which have to be considered.

Insured Understanding - The more uninformed buyer will benefit from being able to tie his insurance program to one policy that he adjusts as indicated by the changing events in his life. He will not need to coordinate the variety of benefit periods and levels, and premium periods and levels of multiple policies. The Adjustable Life (A.L.) policy focuses on the key elements of premium and coverage and thus de-emphasizes the technical plan designation.

The complexity of the adjustment provision necessary to create the flexibility in an Adjustable Life policy may negate the positive results of having only one policy. More importantly, our insurance buying public is probably not ready to intelligently utilize the amount of flexibility that an A.L. policy can contain. Our field force will have to become very active advisors to help the consumer make the best use of this flexibility.

Agent Understanding - The agent has historically worked in terms of plans - the reduction of the term and permanent categorizations will create anxieties. At this stage, the detailed workings of Adjustable Life are difficult for an agent to understand. Without the agent being comfortable with the concept, the communication to the prospect will not be as good as it should, and thus, the whole concept may falter. These facts point out the need for a very strong training program for our agents to provide them with the tools to build their understanding.

The agent's involvement in this product can best be compared to a good agent's involvement with the insurance programs of his clients. The need for review of the insured's program and the ability to make the needed changes within this policy helps tie the insured to our company and our agent. These client control aspects of Adjustable Life will help remove the competition for subsequent purchases. This will not be automatic. The agent and the company must establish themselves with the client. This process can be encouraged by Adjustable Life.

Compensation and Award System - Our agents must view the compensation as equitable in relation to the compensation package to which they are accustomed. In addition, the agents must see that they are being adequately compensated for the service demands of the product. Certainly a compensation package that looks like traditional compensation would most easily be perceived as fair. However, a uniform commission rate (both first year and renewal) for all coverage and premium paying periods may be necessary to handle the flexibility of A.L. This does not preclude a more revolutionary approach to compensation that is perhaps more fitting to A.L. However, given New York restrictions, given the necessity for agents perceiving comparability, given the flexibility of the product, given the de-emphasis of the technical plan designation, and given the service demand, both currently and in the future, a difficult challenge awaits us in the compensation area.

Industry awards such as Million Dollar Round Table and National Quality Awards, and company awards such as top club qualification, contest credit, production, premium, policy count credits, and persistency measures must all be handled in a method comparable with traditional policies and consistent with the A.L. concept for these awards to produce a favorable marketing environment. The agent compensation concerns and the awards concern must also be solved for agency management. Since the management compensation depends on agent compensation, most of these concerns will be alleviated by solutions to the agent questions.

Increased Dependence on Home Office Illustration Services - We have always heavily utilized a personal sales illustration service. With A.L. we must have personalized sales illustrations available. There is no other feasible method. Further, we must rely on this system to produce personalized change illustrations. Since we in the field have no good alternative method, we must be assured the illustrations can be delivered. We must explore ways to make this delivery as fast as possible.

Additional Sales - I have no crystal ball, but I would not expect A.L. to produce vast amounts of new sales initially. Certainly, I think we would see A.L. being used in place of other products. However, there is opportunity in subsequent years for increased coverage. Due to the opportunity for enhanced client control and followup, we should get the subsequent purchases made by the individual. Not only do these sales represent, to some degree, additional sales we would not have otherwise gotten, they represent high quality sales.

Replacement Concern - A Twofold Problem - First, consolidation of several policies into one is a potential use of Adjustable Life. This ability of A.L. could lead our field force to increase their replacement activity. Controlling this will be a challenge. We must emphasize that an Adjustable Life policy fits nicely on top of good basic coverage that may already be in force.

Secondly, Adjustable Life may be a candidate for replacement by other companies' agents who do not understand the A.L. concept. Our challenge here is to control this by good client understanding that can only be produced by clear company-agent-client communication. Given this good understanding, Adjustable Life would actually become a somewhat replacement proof.

Can we eliminate many traditional contracts - streamline our portfolio? Yes, this is desirable in the long run. However, I feel we should move slowly in this area so as to not remove too much of the familiar too fast.

Also, the acceptance rate of this new concept will be different for agents versus brokers, and different for subgroups of each type of producer. We must also keep a portfolio for our field force in states that haven't approved A.L. As A.L. evolves, our results will indicate the right time to trim the other plans from our portfolio. Initially, we should remove only those little used policies that produce pricing inconsistencies with Adjustable Life.

What markets will A.L. appropriately hit? - Adjustable Life has the flexibility to operate in many markets. Where change can reasonably be expected to occur, either in insurance needs or in premium capability, Adjustable Life is a natural. This would include juvenile insurance, insurance for young couples, individual policy pension trust and various estate and business needs where the coverage must move with the unmet liquidity needs and premium availability moves with company earnings or cash flow. Within fairly broad limits, A.L. has the ability to equalize premium outlays for different age and underwriting class of risk. This characteristic enhances the application of A.L. in all markets that involve insurance purchased by someone other than the insured. This could include gifting programs and various business situations where several individuals are to be covered.

At this stage, I can see many places where Adjustable Life fills the bill better than our existing portfolio. The producers working with day-to-day sales situations will identify the best markets. We must be conscious of two things. Adjustable Life is not appropriate for all sales situations, and each new sales idea that we become aware of must undergo careful evaluation. By communicating the good approaches more broadly, the use of this product will be enhanced.

What is the direction of the industry? - I believe the direction is toward more client concern. Emphasis is being placed on cost of policies, and education of the buyer. Continual concern is voiced about the high turnover of agents and the detrimental effects on the customer. More and greater attempts are being made to provide the needed coverage for an individual.

From a population point of view, mobility is great, both in employment and living addresses. Positions of persons change rapidly and in varied directions.

We are operating in a world where change is frequent and in varied directions. Suffice it to say that A.L. has the potential to fit what I perceive to be happening better than any other life insurance concept.

Now that I have had my shot at this, let me turn it over to Wil Kraegel who is acting as Chief Actuary of Hypothetical Life.

MR. WILFRED A. KRAEGEL: Thank you, Jim. President Bob, I think that I have more questions than answers by good measure at this point. As we talk about going into Adjustable Life, it is very important to recognize that after the first decision, whether or not to do it, there will be many, many more decisions. Because the list is so long, and possibly for easier reference, I will discuss the actuarial questions in outline form.

A. General

1. Adjustable Life is "not just another contract." It has fundamentally unique qualities:

    a. In a sense it is just one plan (i.e. one contract form) -- but that one plan offers a full range of plans (i.e. premium payment and coverage periods).

    b. It can combine coverages issued at different times by permitting the full range of prospective actuarial relationships.

    In short, it is not tied to the traditional fixed actuarial relationships (such as in Whole Life or 65 Life or 30 Year Term) either at issue or at the time of a subsequent change.

2. Because it has unique qualities, Adjustable Life needs some rethinking of the usual ways of doing things.

3. Let's look at some of the actuarial and other financial concerns:

    a. How should the permanent/temporary combination of coverages be handled?

    b. What reserve basis should be used at issue and what should be guaranteed for future changes?

    c. Should this contract supplement or supplant the others? How can the pricing be made compatible and consistent with other policy contracts?

    d. What are the tax implications of such a contract?

    e. What should be the compensation structure for agents? Does NY Section 213 pose any problems?

    f. How can mortality and lapse studies be made after the first change?

    g. How should expenses be allocated after the first change?

    h. Are there any special problems with the actuarial functions?

    i. Should the contract be par or non-par?

    j. Should cost of living and guaranteed purchase (insurability) provisions be made an integral part of the contract? If so, what might we estimate as to the acceptance rates and the subsequent experience?

    k. Will lump sum payments be accepted? If so, what are the implications for existing business in this company? In other companies? Will this aggravate this replacement problem?

    l. Can the actuary finally explain the life insurance contract to a layman -- or will it be more difficult than ever?

m. Which records must still be retained?

n. Are there any special problems of Waiver of Premium or Accidental Death Benefit areas?

o. Are cash flow questions altered in any significant way?

B. Permanent/Temporary Combination Of Coverage

There are different approaches to the concept of adjustability, and one of the distinguishing characteristics is how the combination of permanent and temporary coverages is handled. A similar decision has long been with us for non-adjustable plans, and the solutions have included term riders (or separate term policies), step-rate or L-shape plans, plans with a term portion gradually filled in by additions, and fund or annuity plus yearly renewable term. Very likely there are still other approaches which may be used. Adjustable Life requires a similar type of decision, and offers at least one unique way to handle the combination. The approaches follow:

1. The one-policy approach

This is the approach introduced by Minnesota Mutual and Bankers of Iowa. In effect, it blends premanent and temporary coverages by offering a complete continuum of premium/coverage periods, from, say, 5 Year Term to 10 Pay Life. And Term to 87, for example, may be roughly equivalent to Whole Life with a small term rider. Its advantages are its flexibility within one policy, and its emphasis on needs and ability to pay, not on plan. Its disadvantage is that the long-duration term cases may not be upgraded to provide lifetime coverage.

2. The policy plus rider (or two-policy) approach

Here a permanent policy with premium level equal to or greater than Whole Life would be the same as under the one-policy approach. For lower premium levels, the Whole Life permanent adjustable policy would be supplemented by an adjustable term rider (or separate term policy). Its advantages are that it is more like existing plans, and it avoids long-duration term. Its disadvantages are its greater systems complexity and the need to deal with two parts.

3. The step-rate or L-shape approach

The step-rate and L-shape are essentially the same since each is an alternative to the other, just as in current versions of step-rate. In the step-rate, the face amount stays level for life, while the premium increases at a predetermined duration. In the L-shape, the premium remains level for life, but the face amount decreases at a predetermined duration. The advantages are its ability to be used in pre-programming the policyowner's future needs. Its disadvantages are inconsistency with the adjustable idea (no need for pre-programming).

4. The fund (or annuity) plus YRT approach

   Here the face amount is selected, and the premium is used to cover YRT charges for the face less the fund, with the balance being added to the fund. Its advantages are its simplicity in understanding and in systems. Its disadvantages are its lower marketability, its uncertain tax results, and its characteristics at high ages.

In each of these approaches it is important to remember the open-end nature of an adjustable policy. Traditional policies tend to assume that the factors and relationships will follow a pre-set pattern without change to the time of death or maturity (or prior surrender). The adjustable policy assumes that changes are likely in the future, so the current relationships should not be looked upon as continuing indefinitely; on the other hand, they may continue without change, so the possibility must still be recognized.

C. Premium/Reserve Basis and Guarantees

1. Three levels of guarantee are possible (and there are variations of each):

   a. Guarantee all future adjustments at the premium/reserve basis specified in the contract, probably the same one applicable to the initial policy.

   b. Guarantee only the right to adjust, not the basis.

   c. Guarantee neither the right nor the basis, but incorporate old policies into a new one by practice.

2. Guaranteeing the premium/reserve basis for all future adjustments to that policy:

   a. Advantages: attractive to policyowner, both at time of sale and at time of change; simpler for future processing requirements; seems compatible with purposes of life insurance.

   b. Disadvantages: may lead to financial anti-selection; also may require some form of additional premium to cover the guarantees -- hence, has less competitive cost in the normal comparison; inconsistent with normal guarantees of life insurance contract, which cover present contracts into the future, not future increments (even guaranteed insurability and term conversions do not insure the basis of the increment).

3. Guaranteeing the right to adjust, but not the basis:

   a. Advantages: still provides the essence of adjustability without the problems of guaranteeing the reserve basis also.

   b. Disadvantages: loses some of its marketing appeal.

4. Guaranteeing neither the right nor the basis, but incorporating old policies into a new one by practice:

    a. Advantages: essentially equivalent in practice to guaranteeing the right to adjust, but with no commitment to continue if the procedure doesn't work out well.

    b. Disadvantages: since nothing is in the contract, there is limited marketing appeal.

D. Supplement Or Supplant Other Plans?

1. How should Adjustable Life fit into the product portfolio? The choices are:

    a. Replace all other plans -- This is theoretically possible, but it would complicate adjustability, and it could create serious transitional problems for agents.

    b. Replace only the primary life and term plans, including Whole Life, Limited Pay Life and Level Term -- This is not as potentially traumatic as the preceding one, but it could still be difficult in transition.

    c. Include adjustability in each traditional contract, with the emphasis being on flexibility for subsequent change -- This would be much easier for the agent to deal with, since adjustability could be accepted in stages.

    d. Add Adjustable Life as a new plan, supplementing the regular portfolio -- This is the easiest in transition, but it complicates pricing. Consistency between Adjustable Life and other plans will be difficult to achieve.

2. If Adjustable Life is a supplemental plan, it will be necessary to examine each pricing factor in the Adjustable Life to determine if it should be the same as, or different from, its counterpart in traditional plans. Separate experience studies should be maintained to reflect the distinctive characteristics.

E. Tax Implications

1. Federal Income Tax -- The FIT will be affected in different ways by different approaches.

2. State Premium Tax -- There should be no problem in identifying premiums in the usual way for premium tax purposes.

3. Tax upon constructive receipt -- The tax considerations here should be the same as in traditional plans.

4. 4-out-of-7 Rule -- That rule is worrisome for Adjustable Life, since, literally translated, the rule starts over again for the full contract when the premium is increased. Obviously, the rule was not intended to apply to the Adjustable Life situation.

F. Compensation For Agents

1. Two approaches may be used for increases in coverage:

   a. Traditional -- A completely traditional approach can be used, paying commissions on each segment of premium just as if it were a separate policy.

   b. Blending -- Another approach retains the spirit of the traditional but simplifies calculations by combining the commissions for the previous premium with those for the current increment. A new blended set of commission factors would apply from the time of change forward. And this could be done repeatedly.

2. As to what actual rates should be used, again it is possible to use essentially the traditional, with variations according to premium period and issue age. Or a single rate may apply to all "plans" under the Adjustable. Or some completely new rates may be devised.

3. New York Section 213 is potentially a greater problem if the compensation pattern is changed.

4. A practical problem occurs whenever the premium on the policy decreases -- which agent should bear the burden? Another occurs when the "plan" changes, if commission rates are different.

5. A dramatic departure from the traditional would be to base compensation more on service and ongoing relationships, which presumably would result in increments in coverage whenever appropriate.

G. Mortality and Lapse Studies

1. Actuaries want to know about select and ultimate mortality experience. The only way to accumulate the requisite data is to maintain separate records of amounts at risk for mortality purposes. An analogous statement applies to lapses.

2. There may be a way to blend the data and still maintain adequate control over experience. If it is at all possible, it will require imaginative new actuarial techniques. The study and design and interaction necessary to achieve this (or show that it cannot be done) have not yet taken place.

H. Expense Studies and Allocation

1. Again, a statement may be made analogous to that above for mortality.

2. A blending approach appears much more feasible in the case of expense studies and allocation, however.

3. Generally in the past, cash values have been equal to reserves less a surrender deduction. More recently, some companies have moved away from that relationship, viewing the cash value as an independent function. For the Adjustable Policy, however, there seems to be merit in making cash values exactly equal to reserves on the

CRVM basis. This appears to do adequate justice to expense allocation for early terminations, and it greatly simplifies the record-keeping implied by surrender deductions on each increment within the policy.

I. Special Problems With Actuarial Functions

1. Actuarial functions are related to the types of contracts which are desired. Functions currently being used were developed in the context of the contracts originated decades ago.

2. With the advent of computers and changing policyowner needs and adjustability, new types of functions will be developed. But they will be improvements to meet calculation needs more directly and efficiently; it is not likely that they will be problems, since we can use the current ones if we wish.

J. Par Or Non-Par Contract

1. To a substantial degree, this question can be answered in much the same way that it has in the past, based on marketing considerations.

2. At least one new ingredient is the potential guarantee of the reserve basis for future increments in coverage. Because of the uncertainties, this would be more difficult to price competitively in a non-par contract.

K. Cost Of Living and Guaranteed Purchase

1. These are highly desirable additional benefit provisions, and it is desirable to make them as much a part of adjustability as possible. In fact, adjustability offers a more practical approach to the large-scale task of providing COL increments than any previous approach.

2. Experience is already being accumulated by two companies, and more experience will accumulate fairly rapidly. If the reserve basis for future increments is guaranteed, this will make early efforts at estimation more critical.

3. As to guaranteed purchase (insurability), it may be well to treat this in the usual way during the first few years of adjustability. When the concept of adjustability is more clearly understood, then we can make guaranteed purchase (insurability) a more integral part of it.

L. Lump Sum Payments

The nature of an adjustable policy requires the capability for accepting the reserve of an older amount of coverage into the calculation of the premium for the new total coverage. It is a very short step from that point to the point of being able to accept the cash values from other existing policies in the same company -- or even in a different company.

M. Understandability To The Layman

Life insurance has been faulted for being hard to understand. Can the adjustable idea make the concept of life insurance more understandable for the average person?

N. Records Retention

Adjustability makes it possible to combine a number of records, such as for premium billing and accounting. There are some records, however, which must be retained for the incremental pieces, e.g. for various actuarial studies. We may find a way around them, but initially we should assume they are necessary.

O. Special Problems Of Waiver Of Premium And Accidental Death Benefit

1. The Waiver of Premium benefit normally should be no problem, since it can always be handled on a prospective basis for the new premium level at the time of a change in coverage. The usual underwriting for an increase in face amount should suffice for WP. There is a possibility of anti-selection at the time of a premium increase with no change in face amount, however; some type of underwriting review would then be required.

2. At first look, it seems that ADB can be handled in much the same way as before, except that it would have to be as adjustable as the basic policy.

P. Cash Flow Questions

1. Adjustments to a policy may be up or down. Will this influence cash flow in any way different from the analogous effects of new issues and surrenders in traditional policies? Will liquidity requirements be different?

2. Would adjustability cause an acceleration of movement to lower premium levels per $1,000, particularly to intermediate and long-duration term?

3. Will policy loans be more or less prevalent?

Those are some of the primary questions on the actuarial side. At this time I would like to turn to Bob Senkler who will talk about the administrative aspects of Adjustable Life.

MR. ROBERT L. SENKLER: When one considers the introduction of Adjustable Life, it is apparent that the contract has great sales appeal, in addition, the mathematics of the contract as outlined in Walter Chapin's paper is a well developed package. However, the administration of the policy reminds me of one of Weiler's famous laws. Nothing is impossible for the person who doesn't have to do it. Administratively, the contract will create problems.

In determining the administrative procedures required for the Adjustable Life Policy, the major item to consider is how Adjustable Life is different from our traditional policies and to determine the problems these differences will create. The major difference between Adjustable Life and our traditional policies is the Adjustment Provision. This provision allows an insured to reissue his policy, changing any combination of the face amount, plan of insurance, or premium. This creates a problem since our current daily cycle record cannot retain the necessary information to reissue the policy. The additional items needed include: the previously taken expense allowance, expense allowance taken at the last reissue, and the reserve credit at point of reissue. Another problem arises since a policy could be reissued for an increase in premium which would require the payment of additional compensation. Given the current agency system, the information required to properly compensate the agent would not be available.

Due to this deficiency, our daily cycle system will have to be changed or an additional record will have to be created to retain these items. From an administrative standpoint, the most desirable would be to completely revamp our current system to accommodate the policy. From a practical standpoint, a separate record would seem to be more feasible. In addition, it would allow us to become more familiar with the product, thus enabling us to create a better overall system in the future.

The major problem associated with the dual record system is consistency. The magnitude of this problem depends upon the amount of manual intervention that will be required in updating the record. The solution to this problem is to minimize the amount of manual input and to develop a system that will compare certain key items within each record. When a discrepancy is found, it will have to be investigated and corrected. A similar problem associated with the reissuing of a policy is the hand calculations that will be required. If at all possible, the previously taken expense allowance and the reserve credit should be computer produced when the policy is reissued.

The next area in which the Adjustment Provision will create problems is the communication that will be required when the policy is reissued. The reason the communication is so important is because a reissue can completely change the policy's values. The death benefit, premium, plan of insurance, nonforfeiture values and even the anniversary date of the policy can be changed. Thus, the communication that the insured receives will have to clearly state how the policy was affected and what the new policy information page represents. This is especially critical when we are dealing with orphan policyholders since the only communication they receive is from the Home Office.

As I mentioned above, the Adjustment Provision causes two basic problems. The first is the actual reissuing of the policy and the need for certain items which currently cannot be retained in our daily cycle record. The next problem is the payment of compensation when a policy is reissued with an increase in premium. Although the actual solution to the compensation problem will depend upon what type of compensation package is developed, the basic record-keeping requirement does not depend on the compensation method. What is needed is the ability to trace the past premium pattern of the policy and if the first year compensation depends upon either the plan of insurance or premium per thousand, this information will also have to be retained. Once again, the administrative problem stems from the fact that our current record-keeping is not set up to handle the flexibility of the Adjustable Life policy.

In addition to the problems directly associated with the Adjustment Provision, there are several areas that will require the development of additional administrative procedures. The first of these deals with the fact that regardless of the plan of insurance, every Adjustable Life policy contains cash values. This will create a potential over loan problem for all Adjustable Life term policies since the cash value will decrease at later durations. To avoid this problem, we will have to develop a procedure that will identify policies in which the current loan exceeds the available loan value at the next anniversary. When this occurs, the insured should be notified that during the year, a periodic loan repayment will be required to avoid the lapsing of the policy.

The next area that will require additional administrative procedures is with respect to the dividend options that can be accommodated within the Adjustable Life policy. On traditional policies, the dividend can be applied to reduce the premium, paid in cash, purchase additional insurance or be accumulated at interst. Adjustable Life can accommodate the standard options but due to the flexibility of the policy, we can also develop a dividend option that will improve the plan of insurance. I'll refer to this option as policy improvement. On term plans of insurance, this option places the dividend into the cash value of the policy, extending the plan of insurance. After several dividends have been declared, it would be necessary to update the policyowner's policy information page. The decision has to be made on how often this should be done and develop a method that would minimize the cost. When first considering this dividend option, it might seem as if the cost would be prohibitive due to the required updating. However, if an Adjustable Life policy is serviced correctly, this should not be a problem since any reissue would automatically update the policy. In addition, we should be able to develop a procedure that will create effective service opportunities for our field force and increase the chances for repeat sales.

Although the flexibility contained within the policy will create problems, this flexibility will also allow us to service our policyholders more efficiently. Administratively, the premium reduction feature will be very effective within our policy conservation area. It will create one more tool that we can use in avoiding a lapse or partial surrender of the policyholder's insurance protection. This flexibility should reduce the number of policies per insured. This, in turn, should reduce the amount of work involved in the basic policy maintenance. It will also allow us to create more efficient service opportunities for our agents and will allow us to provide this service on a more consistent basis.

In concluding my remarks, there is only one basic question to answer when deciding whether or not to introduce Adjustable Life. Are we willing to put forth the effort to provide for the policy's flexibility, and is this effort worth the benefits this flexibility will provide?

The next area to consider when developing Adjustable Life is with respect to data processing. Stan Hill, our Chief Data Processing Officer, will describe the items to consider.

MR. J. STANLEY HILL: When President Bob gave me this study assignment, he asked me to deal with questions in four areas. The first of those areas he phrased this way, "What special aspects of Adjustable Life must be kept in mind in designing or modifying our computer system?" I have listed four items in answer to that question. The first one is how can the great array of actuarial formulas be most readily reduced to a workable program which will be compatible with our present daily cycle routines. In looking at Hypothetical Life's particular situation I think I would like to ask for the assignment of a couple of bright actuarial students who will be with me for the duration. The first thing I am going to do with them is lock them in a room with a couple copies of Walter Chapin's paper and tell them not to come out until they thoroughly understand it. We'll send food in. Seriously, I do believe that it is easier to educate these actuarial students on the ins and outs of programming and operating our computer system than it is to try to teach one of my career programmers the ins and outs of Walter Chapin's paper. At least I do not want that assignment.

The second special aspect is the great deal of special data that must be carried for each Adjustable Life policy. Bob Senkler has alluded to several of those. I have counted them up to the best of my ability and I am finding that we would need 60 to 70 additional fields in our master record for the unique aspects of Adjustable Life. Very frankly, that would sink our present daily cycle system even though we designed it with great flexibility and the capability of trailers. So, I think that for starters and temporarily, we must have a separate Adjustable Life minimaster record which isn't so mini for starters. I'll deal more with that under the next question.

The third area of special consideration is this. I think that a computerized proposal generating system or sales illustration generator is a necessity for Adjustable Life. And such a system will depend heavily on the actuarial formulas that we mentioned above. We do have a choice as to whether we try to build that into our present computerized sales illustration system or whether we set up a separate one for Adjustable Life. Frankly, the jury is still out on that area.

The fourth item has to do with the inevitable question that is if we set up a separate computer system for handling the unique aspects of Adjustable Life how will it communicate with our existing individual life insurance daily cycle system and how are we going to keep the two synchronized. Here I propose that any policy change information other than what we call the non-unique fields, anything that smacks of a policy change, has got to be put in through the Adjustable Life system. That system will create an output segment which becomes the input segment to our daily cycle and will be compatible with our present daily cycle. Any other input into the regular daily cycle record on an Adjustable Life policy will be forbidden.

The second question which President Bob asked me to deal with has to do with what areas of our present daily cycle system will be most effected by or will require separate routines for Adjustable Life. Frankly, it is easier for me to turn that question around and say what areas aren't effected? I'm serious about that because the only areas I can list that are not effected here are policy loan processing and accounting, commission <u>accounting</u>, and production and contest credit, name and address changes, premium billing, collection, and accounting for what we call the conventional dividend options. I put the emphasis on accounting because of course commission calculation is vitally effected.

The third question is how are we going to approach our systems work here to set up the necessary systems and programming for Adjustable Life. Here are the principle alternatives that we considered. Do all the systems and programming in-house. That's one. Secondly, we can acquire an Adjustable Life system package including master record layout, transaction codes, data input formats, the whole works, but do the coding in-house. And the third way would be to acquire a so-called turn-key Adjustable Life package for mounting on our own computer and take it from there. I want to emphasize if we go either of the latter two approaches I am going to insist that we have salaried people in-house who understand these systems completely. We are not buying anything that we do not understand and cannot operate and support ourselves.

Finally, the last question was how are we going to interface our Adjustable Life programs with our existing system. These are important considerations from both the administration and data processing standpoint. One method is to modify the present individual life administration system to handle Adjustable Life by calling Adjustable Life routines where appropriate. I think that this is the ultimate. I think this is where we are going to end up some years down the road. But it just takes too long to get there because that involves a very, very major overhaul. So we've got to start some other way.

The second is to set up an independent system to handle only Adjustable Life policies, but handle them completely. In other words, to parallel our present system.

The third is to set up an independent system to handle the unique aspects of Adjustable Life with appropriate inputs to our regular system to handle the non-unique functions that I mentioned above.

The fourth would be to make use of a time-sharing service which will handle all of the unique aspects of Adjustable Life and which provide appropriate inputs to our regular system to handle the non-unique functions.

I favor one of these latter two approaches for starters. Either set up our own system or use the time-sharing system to get us off the ground quickly and running. Granted it will have some administrative inconveniences in making the systems talk to each other but Bob, you've talked to the guy at Minnesota Mutual who has run this thing for four years and he's still smiling. So, I think maybe we can swing it. That's about it Mr. President.

MR. HOGUE: Okay, that is the report from the management team. Now we'd like to hear from the attendees.

MR. WALTER N. MILLER: I remember when the Bankers Life introduced this policy, one of their people was quoted in a national magazine as saying that their development work involved 25 man years of programming effort. That is a lot more than it takes any of us to completely revise a conventional ordinary insurance portfolio. So, this is a big decision that you are wrestling with.

It seems to me that you are trying to frame this decision strictly in terms of black and white, go or no go, should we introduce Adjustable Life or not introduce Adjustable Life. Have you given any thought at all to intermediate courses of action that would require a lot less than 25 man years worth of programming effort? Isn't there a lot you can do with your present product in terms of beefing-up guaranteed insurability options? Building into some of your base policies, some specific types of flexibility options or plan change options at original age premium rates would be an alternative to Adjustable Life. Reduced paid-up and extended term, after all, are not the only things that can ever happen if premiums are stopped. Why haven't you considered some of these?

MR. CHARLING: Mr. Miller is certainly right at least as far as our best estimate of the time involved is concerned. The quote of 25 man years in the EDP department is our best guess. The time involvement of other areas of the company was equally as substantial in total.

MR. HILL: Hypothetical Life has been trying to find more conventional alternatives to Adjustable Life for the last ten years, and yet, it is an idea that will just not go away. They finally just decided to go ahead with it.

MR. SENKLER: When you put more flexibility in other policies your administrative problems are not solved. Any additional flexibility you put into traditional policies will also increase your administrative problems. Data processing work will be needed, and although it will not create as much work as Adjustable Life, it does not provide the flexibility that Adjustable Life can provide.

MR. KRAEGEL: The reason that Adjustable Life is having increasing appeal is that as we have improved our existing contracts and as we have tried to provide a greater variety of options and benefits and a greater consolidation of the program of any individual by bringing policies together through the data processing system, the more we have increased the complexity of our existing system.

The policyowner should have a nice succinct summary of the contractual relationship between that policyowner and the company. The more we try to do that, the more difficult it is, the more complicated it is, the more forms we are sending out, the more postage we are paying, and the more computer inter-relationships exist among a wide variety of records. Adjustable Life is hopefully a way to cut through that.

In his initial remarks as Chief Data Processing Officer, Mr. Hill mentioned the 60 or 70 extra records, but remember that when you are comparing an Adjustable Life with a traditional policy, you must do so with comparable situations. At issue they are essentially the same. There is no reason for them to be different. After the first adjustment, however, the adjustable policy is more complicated than the traditional policy. But, the adjustable policy, even with more fields, still has significantly less data required than two policies on the traditional basis. The more adjustments you make, the more the advantage of the adjustable policy increases. Over time, the large initial cost should be much more than offset by the savings that will be obtained by having a consolidated program for the policyowner through the Adjustable Life policy.

MR. HOGUE: In the industry right now there is a lot of "non-standard" product development activity going on. Universal Life or Term-Fund products and Adjustable Life have generated a great deal of interest. There is also increasing interest in index related products. The smaller companies are showing more interest in "unique" policies and packaging. The underlying trend seems to be an abandonment of the fixed plan structure. The Hypothetical Life is considering Adjustable Life because of the nature of its writing agent distribution system. We have a vested interest in preserving it. Companies that must protect career agents tend to think of Adjustable Life, which those with brokerage or PPGA outlets tend to lean toward the term-fund approach. The former seem pressured to protect agent's income, while the later seem pressured to drop costs, to be more competitive, and to develop something that is unique.

MR. J. ROSS HANSON: My compliments to the company officers on their very thorough analysis of the situation. In keeping with your format I suggest that I am the President of the Hypothetical Consumers League. I would like to ask the company officers a couple of questions.

The first is, in our opinion, the one and only question that you must ask yourself about whether you are going to Adjustable Life: Will it produce a better value for the policyowner over his lifetime? You must be able to demonstrate that to yourselves if you are going to make a decision to develop an Adjustable Life policy. Have you made that inquiry? The second thing is, we as consumers are very concerned about understanding this life insurance business. We simply do not know what goes on. Will you be making an effort, in the development of this product, to make it comprehensible to us?

MR. KRAEGEL: As far as costs are concerned, I certainly agree that if this is not going to be better for the consumer from a cost standpoint in the long run there are serious questions as to whether we should do it. There is an advantage beyond cost in having the consolidation, in having the program expressed as a single face amount and a single premium payable. That should be worth something to the policyowner. Ultimately we need more than that.

It is hard at this point to state clearly just how much savings could be achieved, but I see an unmistakable trend among life insurance companies to do more and more for their policyowners in terms of bringing together information about existing policies of that policyowner in that company. There is no question in my mind that it will be cheaper to do it by the single policy route than by the multi-policy route.

MR. CHARLING: The easiest way for me to look at the understandability is to think of the insured that has only an Adjustable Life policy. With the one policy, the person who started on Adjustable Life has one data page and one policy at any point in time which tells him he has coverage of a certain amount for a specific period of time, and he is obligated to pay premiums of a given amount for this period of time. That is fairly simple. All of the other policy provisions are somewhat comparable to the current situation.

One of the other things that would help understandability is that we would, ideally at least, have an agent on the scene. There would be an agent on each policy at each point in time. The agent is the helper in understanding what is on a policy. Adjustable Life affords us the extra opportunity to provide a way to get that agent there.

MR. KRAEGEL: We are not doing as good a job in the industry as we could be doing in providing policyowner service. The number of policies per policyowner in a company is now quite small and indicates that there is not a successful attempt by a company to upgrade the policyowner's insurance coverage the way it should be upgraded. If it were done the way it should be, each policyowner over a lifetime might very well have 15 or 20 policies. I am comparing the Adjustable policy in terms of the kind of contractual relationship that we should have over the lifetime of the policyowner. When you compare Adjustable Life with a large number of policies on a single life, the Adjustable Life approach shows a stronger potential for cost savings.

MR. ROBERT L. SPIES: It seems to me that the non-par alternative and also the accumulation fund plus term were sloughed off a little too easily. You are eliminating a large number of companies from selling this kind of product. I wonder if the main reason for this is the compensation matter. Tax implications were mentioned and also the old age problem. Is it possible that a term plus an accumulation vehicle would be so highly advantageous to the consumer that tax situation or no, he could still get a better deal? The old age problem could be solved by having paid-up insurance available so that the term piece does not become outrageously expensive. The simplicity of the administration and the simplicity of the computer system would be greatly enhanced in this kind of a scenario, costing a lot less money. I wonder if ways can be worked out to distribute this kind of product so that the agents are compensated adequately for their efforts and yet still give a policyholder a better deal.

MR. HOGUE: I see high development costs for Adjustable Life. These have to be justified by high long-range benefits. In the short run Universal Life is less costly to develop, but in the long run it will be less profitable to both the company and to the agent. A choice between them should be based on comparisons of relative returns on investment funds and levels of agents' income produced.

MR. KRAEGEL: I agree that the fund or the annuity plus YRT has a great deal of conceptual appeal. I do not know how the average consumer will regard it but it seems simpler to me. The main reason that this has not been attempted in the past is because, until recently, we did not have the computer capacity to do that and have any kind of flexibility. It is really a very recent phenomenon that we can even consider that kind of policy. If it is, indeed, something that can be sold, that can be marketed through paying the agents in some other way in order to make it worth their time to sell on that basis, then I think it will happen. It is not consistent with our current distribution system, and we have a tremendously large and involved distribution system currently. This is not the kind of thing that can happen overnight. If this has merit, and there are some aspects of it that have merit, I think that there will be companies that will be trying it and will try to make it work.

There are advantages to the current system too. There are advantages to the traditional cash value build up, and it is hard to ignore the tax considerations. We will see what happens ultimately in the marketplace.

MR. SENKLER: The only thing I would like to add with respect to our non-participating company is with respect to Adjustable Life. The biggest problem is trying to predict what the costs will be of the changes and of guarantees that are involved in the premium structure of Adjustable Life. It is very hard for a non-participating company to have a guaranteed premium rate for 20, 30, or 40 years in the future, to have the types of options that are currently available (e.g., guaranteed insurability option, cost of living options), and to guarantee those rates in the future.

MR. HOGUE: Here is a scenario for people to think about. Pressures for change in the valuation and non-forfeiture regulations exist. They have recently affected the flexible premium annuity. They have caused problems for index related policies, for the Variable Life policy and for a few lesser known product innovations. The result has been a pressure for changes which will accommodate unique and novel product innovations. We are now seeing two such policies. One is avoid the minimum non-forfeiture and the valuation requirements by adopting a pure-term and pure-investment split product structure while the other maintains its life policy status. In theory, the two approaches should yield identical results. I envision that ten years from now both of those approaches will in reality result in identical results. By that time, these basic laws will have been changed to accommodate such product innovations, and to treat flexible and fixed plan products in an identical way.

MR. THOMAS S. FERGUSON, JR.: Here is a question for Jim Charling, Marketing Officer. One of your chief long-term objectives is to develop new agents for your sales force. Do you see Adjustable Life as being helpful in this area or is it the kind of product that a new agent just can not learn because it is too complicated?

MR. CHARLING: I believe Adjustable Life may be easier for a new agent to learn, than for an older agent. The new agent does not have to unlearn the current plan approach. One of the most easily identified markets of Adjustable Life is young people, people who have got enough future so that you can not assume anything but change. An additional useful characteristic is that the nature of Adjustable Life aids in client building. I view Adjustable Life on balance to be favorable toward agent building.

MR. SENKLER: What you have to do is look at the original issue sale. The agent goes through a fact-finding interview, finds the amount of insurance needed and the ability to pay. If you have traditional policies only, you have to fit that into a whole life policy with riders, term to 65 or some kind of fixed combination. For Adjustable Life, as long as that fits into a very broad plan range, the agent can make the sale. The agent does not have to become familiar with 10 or 15 policies so it is easier for him.

MR. PHILIP C. GATH: I have a couple of questions about the characteristics of the ongoing product. What do you suspect will keep yourself from being nickeled and dimed to death by the policyholder who sends in a different amount of premium every month. The second problem is to get our share of the investment dollar. This product will have some significant inflation guards such as cost of living riders and GIO riders. When these go into effect do you expect to get an increase in face amount but no increase in premium because the policyholder may change the plan? Do you see these options just diluting your portfolio so that the major part is term insurance?

MR. KRAEGEL: Your term "being nickeled and dimed to death" is an apt one, and it is something that we have to worry about. We must remember that the policyowner will have a specific premium to pay. There will be unusual cases in which a policyowner will be changing frequently, but most policyowners, once they have made a change, will stick with that for a fairly long period of time. Gradually they will become accustomed to this particular approach. They need the agent in order to work through changes. The agents will learn to market in a different way linking the policy with the policyowner's income and number of dependents. They will develop an understanding as to what adjustability is supposed to do, particularly for increased coverage and increased payments at such times as needs increase and/or ability to pay increase.

MR. SENKLER: There are many contract provisions that you can build in to protect yourself from "nickel and diming." It is very important to look carefully at your cost of living agreement, your adjustment provision, and the minimums that are stated within the policy. Define the minimal reissue constraints that your company is willing to live with, put those in the contract and that should remove the problem.

MR. HOGUE: We will go through a closing exercise now. I've asked the panel to generate a little foresight for Hypothetical Life. Assume that the company released an Adjustable Life policy similar in design to those of Bankers Life of Iowa and of Minnesota Mutual. It was released to all of the company's agents at the same time, and the computer systems were up and running when the policy was introduced. No products were dropped from the portfolio when Adjustable Life was introduced, so it competed with the company's traditional products. It is now five years later and we want to evaluate our experience to date, and to describe the current role of Adjustable Life in our operation.

MR. CHARLING: I'll address the problems and opportunities encountered as we gained experience with the Adjustable Life concept. In general, throughout most, if not all, of this first five years, the unknown was the greatest problem and opportunity. Suffice it to say, at this point the difficulties encountered have been well worth the effort.

During the developmental phase the following challenges emerged:

1. orienting developers' minds to the demands of the flexibility without losing sight of necessary ties to traditional insurance forms;

2. developing necessary and meaningful introductory material that conveyed the appropriate message -- especially in key areas like the misuse of Adjustable Life as a replacement vehicle;

3. constructive use of field force input through agent and field management representatives; and

4. interpretation of state laws to apply to Adjustable Life, when most laws don't anticipate such a product. For example, the interpretation of Sec. 213 policy year and year of coverage terms as it applies to Adjustable Life changes.

During the introductory phase we experienced very good field reception, with some exceptions. The exceptions pointed out the need to encourage the use of Adjustable Life without over emphasizing it.

During the early months following the release of the product we saw the young market emerge as the most identifiable one for Adjustable Life. Since agents tend to sell to their own age group, we saw many early sales from young agents. Since young agents may most greatly benefit from the client developing characteristics of Adjustable Life, the results represent a real opportunity.

Beyond the new agent results, the broker production of the Adjustable Life was a bit slower emerging. Significant results are now occurring in that area.

At this five-year point we have had:

1. a significant amount of repeat business, both at Cost of Living and Guaranteed Insurability Option time, and at other times;

2. very few premium reductions (keep in mind the economic cycle has been favorable);

3. opportunity to remove several little-used traditional plans from the ratebook;

4. and most importantly, a growing understanding of the real, positive worth of the Adjustable Life concept.

MR. KRAEGEL: I would like to mention just two things. One, something that worked out better than we had feared; the other something that has been a bigger problem than we had expected. Adjustability turned out to be simpler than we had been afraid it would be. How did that happen? Well, we could see the complexities very clearly as we were going into it. We could not see the simplicities as clearly because it was something that was very new to us and we had to live with it awhile in order to get a full appreciation of the simple aspects of it. That has been a very pleasant surprise.

On the other side of the fence, the biggest problem that we found was that the policyowners, a number of them, desired to place their old policies on the new basis. Now these policyowners see this as a way to update their policies and their whole insurance program. Now the proportion of them that have done this is quite small but in absolute numbers it's a large amount. To the agents that have to go through the process it has been something of a burden.

MR. SENKLER: When first considering the introduction of Adjustable Life, my major concern was that our current administrative systems were not capable of handling the flexibility contained within the Adjustable Life policy. Since we introduced Adjustable Life five years ago, we have discovered many things with respect to the product. The major item was that regardless of what system we decided to develop, we found out that the flexibility of Adjustable Life can be accommodated; that given the proper data processing support, the product can be administrated effectively.

The major ongoing problem associated with the product is with respect to orphan policyholders. This problem has been aggravated by the fact that three states have not yet approved the contract, Pennsylvania, Mississippi and Montana. In addition, not all of our agencies have been active in the sale of Adjustable Life. Thus, when an insured moves into one of these areas, the insured has to rely on the home office for support since our representatives are not familiar with the characteristics of the product. The solution to this problem will lie in better education of our field force and the development of a special orphan policyholder service unit solely responsible for the service of these policyholders.

As we predicted, the reissue activity for Adjustable Life has been very active. Currently, approximately 80 percent of all Adjustable Life policyholders who have had their contract for three years or more have reissued their contracts.

Although less than 10 percent of our reissues have involved a decrease in premium, this premium reduction feature has proved valuable in the conservation of policies. The majority of these decreases have occurred because the insured has had a financial setback.

Our Cost of Living Agreement has achieved wide acceptance. The current acceptance rate is somewhat over 70 percent. The major reasons for this are because of our excellent advance notification and because of the public's awareness of inflation. If we would have introduced this product when inflation was at three or four percent, I feel that our acceptance rate would not have been as high. But when the public is constantly reminded of inflation and since the agreement can keep the purchasing power of the death benefit intact, this combination has contributed to the acceptance rate.

In general, I feel that Adjustable Life has worked well. Through the flexibility provided in the contract, we have been able to service our policyholders in a much more efficient manner.

MR. HILL: Well, frankly fellows I'm in trouble. I got those two actuarial students to decipher Walter's paper and they wrote some beautiful actuarial sub-routines for me. But before we had this thing all installed and running, one of them got quite altruistic and joined Action and is now in Zaire. We are not able to get in touch with him very well. The other was a female actuarial student and she fell in love with the pop singer John Phoenix and is traveling around the country with him now so we are not very well able to keep up with her. The people whom I turned their programs over to say they cannot read the programs so they are going to have to start over again. So I've published my 7th release date now for our new system. It was supposed to be done in 2 years, now 5 years later my friendship with the Chief Administrative Officer is getting tough. And President Bob who was a pretty decent sort up until now says that if I don't have this thing out in May, my successor will not have the same problem. So I have assured him that we will have this new system out in May, but frankly it looks to me as if it will be about May 53rd.