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THE ACTUARY'S RESPONSIBILITIES—PENSIONS

1. Are there, or should there be, absolute requirements concerning the elements (assumptions, methods) that enter into the valuation or costing of pension plans?
2. What should be included in a good actuarial report?
3. What is the actuary's responsibility to management? Stockholders? the public?

Dallas Regional Meeting

MR. DANIEL F. McGINN: For many years, all of us probably have explained to clients and young actuarial students that the benefits and expenses paid under a pension plan must be equal to the contributions paid into the pension fund *plus* the investment income of the pension fund. Consequently, with a static population and a fixed rate of investment return, the ultimate level of employer contributions will be governed by the size of the pension fund and the level of benefits provided by the plan.

In general, this known relationship points to the fact that employer contributions probably will be higher if a unit credit cost method is used than if either an entry age normal or an aggregate cost method is used. However, this relationship between plan benefits, employer contributions, and a pension fund's investment income does not imply that there are any "absolute" criteria for selecting cost methods or actuarial assumptions. It is my opinion that there are certain criteria which provide the minimum conditions that must be met in selecting actuarial cost methods.

The choice of cost method selected by the pension actuary should be one which will satisfy the following condition, since the plan is intended to continue indefinitely: The present value of future contributions for the existing population of employees and the present value of contributions for all future generations of employees *plus* the value of the pension fund assets must be equal to the present value of all future benefits for the current population of employees and the present value of all benefits for all future generations of employees.

Under this condition of equilibrium, we essentially have a relationship between two perpetuities if the pension actuary assumes an ultimate stationary population. Also, under this static population assumption, simplification of the equation develops a minimum annual payment

equal to the normal cost of the plan *plus* interest on the unfunded actuarial liability, where both elements have been determined by calculating the normal cost on a "replacement normal cost" basis. As that phrase implies, the "replacement normal cost" is the normal cost for all employees who will earn benefits under the plan, on the assumption that the plan always existed in its current form. Clearly, the pension actuary should evaluate the condition of equilibrium in terms of the best judgment of the corporation or the board of trustees concerning the growth or decline of the business or businesses in which the employees work. If the industry is growing, then the assumption of a static population will produce a conservative basis for annual cost calculation. On the other hand, if the business or industry is declining or may decline, then the assumption of a static population is invalid, and the actuary should attempt to make a reasonable approximation of the rate of decline of the population to either (1) fix the level of required contributions or (2) fix the level of benefits supportable by the bargained-for contributions under a Taft-Hartley trust.

It is this basic concept of equality between the value of future benefits and the combined value of future contributions and current assets that the professional actuary should use as the foundation for his choice of cost methods. With sophisticated computer systems as a tool, the pension actuary may use this basic concept to select amortization periods and more accurately predict required employer contributions necessary to sustain fixed benefit commitments.

When a plan is first being designed, the actuary must make numerous assumptions which probably cannot be validated until actual experience develops. However, I believe the pension actuary has an absolute responsibility to use those assumptions which reflect the most probable experience which he anticipates. He should not arbitrarily set assumptions so that they are conservative in one area in order to compensate for lack of provision for benefit cost in another area. For example, it is not appropriate to truncate employee turnover rates to approximate a provision for the cost of expected vested pensions. If the actuary's assumption of turnover is truncated, he effectively not only assumes that each employee is 100 per cent vested in his accrued pension credits at the age when the turnover rates are truncated, but he also assumes that all employees who survive to normal retirement age will earn the full additional credits allowed under the plan. This assumption tends to produce unduly high anticipated costs. It is important for the actuary to reflect his best estimate as to the percentage of employees surviving from year to year and becoming eligible for vested pension benefits, dis-

ability retirement benefits, or any other benefits under the plan. For example, if unreduced disability retirement benefits or early age retirement benefits are provided under the plan, it is essential that the actuary make some provision for the rates of disability retirement and age retirement if the estimated costs and plan liabilities are to be at all realistic. If disability or early retirement age pensions are provided under the plan, the actuary's assumptions should be set so that these benefits can be fully funded in the same manner that vested pensions and normal age pensions are anticipated and fully funded. Otherwise, with an immature population the pension plan cost can be substantially underestimated because—by the nature of these benefits—there is a significant deferral of costs.

According to the Society's Opinion S-4, an actuarial report should include the following:

1. The name of the person or firm who requested the report and the purpose of the report.
2. An outline or reference to an available outline of plan benefits.
3. The date of the valuation and information and assumptions as to the census data used.
4. A summary of statistics for the group and the book and market values of assets, as well as the asset values used in the valuation.
5. A summary of the basic valuation results, with a suitable statement of the appropriate range of contributions.
6. Finally, "a statement of the actuarial assumptions and methods, including, where appropriate, an appraisal of their suitability for the purposes at hand and reference to factors which have not been considered. Changes in assumptions from those used in previous reports should be stated and their effect noted." The Opinion maintains that the statement should not merely list the explicit assumptions but should also mention the presence or absence of other factors which the actuary believes to be significant in the evaluation of future cost or the evidence of future costs. Examples of such factors are inflation, margins, and plant shutdown.

I believe that the appraisal of the suitability of actarial methods or assumptions must include an evaluation of whether the conclusion reflects the long-term cost implications for the plan. In my opinion, such an appraisal not only is appropriate *but should be mandatory* except in the case of valuations for special purposes where the costing is not intended to be long term. In other words, the actuarial report should not merely recommend the contribution rate for the coming year in terms of static assumptions. For example, if the unit credit cost method is used, the actuary should not imply that the calculated pension costs

are a measure of the long-term cost unless he has, in fact, based his opinion on a positive evaluation of the present circumstances and future probable changes of significance which bear on the employee population and the future of the corporation or industry.

In my opinion, the wording of this guideline encourages the use of general statements on what possible factors have been omitted from consideration. The statement that inflation, or a decrease in covered persons, has not been considered is of little practical value to the plan sponsor. If the sponsor is alert enough to ask the significance of the statement in the specific set of plan circumstances, the actuary will probably be unprepared to give a specific answer in terms of sound plan finances. Vague statements concerning "omissions" appear to be merely for the purpose of protecting the actuary in the event of serious change in plan finances. In other words, if the actuary believes that inflation will continue or that the covered work force will decline, he should test the financial effect of such an event on a reasonably likely hypothetical basis, hopefully chosen with the help of the plan sponsor. I believe that this practice is essential in giving professional actuarial advice rather than hiding behind a vague list of "nonconsiderations" that is unintelligible to the people responsible for the plan. Of course, if the client is unwilling to pay for the additional cost of evaluating possible future trends or if the client insists on a valuation to produce minimum cost, the actuary is faced with a dilemma. He wants to keep his client, yet he should do what his professionalism demands, that is, "qualify" his opinion regarding the financial results he has developed. The "qualification" should not be an obscure generality—implicitly intended to be overlooked—but, rather, a qualification clearly pointing out the possible implications of the factors omitted from consideration.

Since the actuary is responsible for the reasonableness of his assumptions, he must be convinced by periodic studies of the plan experience that they are reasonable. Ideally, the actuarial report should include regularly a gain and loss analysis and a discussion of the effects of the current gains and losses on the financial status of the plan *and* the expectation of similar gains and losses in the future.

Finally, a good actuarial report should contain clear recommendations of possible courses of future action. The report should not bring the client to a dead stop with a presentation of the static circumstances of the plan's finances. Rather, the actuary's report should point to existing or prospective plan problems and present an outline of recommended steps to solve the problems. If further analyses or studies are required, the report should so state. What we need more than anything else in

actuarial reports are results that show the current financial status, projections that give an insight into the future, and thoughtful and convincing recommendations for timely action wherever it is needed.

Since management retains the actuary, the pension actuary's responsibility is primarily to management. And, because management is charged with the responsibility of maximizing corporate profits both now and in the future, the actuary has the responsibility to use cost factors and methods that will assist management in ensuring that the pension expense charged against earnings from year to year does not interfere with management's capacity to achieve its financial goal. In general, the assumed investment earnings rate is the most important single factor employed by the actuary in his cost projections. Consequently, the actuary has a duty to alert management to the fact that the actuary's assumed investment earnings rate can affect the *incidence* of pension expense but it cannot pay any benefits. Only actual investment earnings and employer contributions pay plan benefits. Therefore, the actuary certainly has some responsibility to assist corporate management in evaluating the performance of its pension fund investment manager. Likewise, if the corporation's plan is based on employees' salaries, then the actuary should demonstrate how the level of pension expense charged to corporate earnings is affected by different rates of change in employee salaries. With the most recently experienced high rates of inflation, the obligation of the actuary to demonstrate to corporate management the impact of the long-term continuation of such rates on pension costs seems obvious. Clearly, if the changes in salaries of employees were to continue indefinitely at an annual rate of 7 or 8 per cent, then the traditional idea of incorporating noninflationary salary-scale assumptions might have to be abandoned; the actuary and management must work together to find additional long-term investment margins to offset otherwise substantial increases in pension expense. Each company's management must be made to realize that the pension cost which is understated today will merely accelerate the rate of future increases in pension costs. There is often a tendency for management and the actuary to rationalize and justify the inadequate provision for current pension expense. Since the actuary probably is the only one who really understands the implications of his choice of factors and cost methods, he has the responsibility to give management sound fiscal advice, not advice born of expediency.

Every qualified pension plan represents management's voluntary commitment of pension expense on behalf of its employees which is intended to be permanent and of indefinite duration. On the other hand, social

security pensions represent the federal government's mandated commitment by management of pension expense on behalf of its employees over which management has no control. Because of this combined pension expense commitment, the pension actuary "owes" management the best possible advice as to how the private plan can be designed to most efficiently complement social security pensions payable now and in the future. Also, the actuary must keep management apprised of federal and state pension reform legislation and revenue rulings of the Internal Revenue Service. In my opinion, the most knowledgeable client generally cannot comprehend these myriad legal factors that constantly change and just as constantly influence current or future pension costs. Therefore, the actuary must monitor the changing legal environment which affects pension plan design and cost, and continually inform management of relevant changes. The primary purposes for which management typically establishes a plan are the following:

1. To provide economic security for loyal employees in their retirement years.
2. To maintain the vitality of the work force by phasing out older employees and providing advancement opportunities for younger employees.
3. To provide a competitive compensation package.

With these purposes in mind, the actuary must design the plan to reflect the particular situation of the company and must work with mangement to devise a plan which will both accomplish corporate goals and, simultaneously, provide employees with the maximum retirement benefit within the cost constraints imposed by management. The benefit formula should be designed to grant equitable treatment for each class of employees covered by the plan, that is, for those employees who have a low income and those who have a high income and also for those employees who have long service and those who have little service. To the extent that the corporate budget can afford to allow liberal early retirement provisions, it is my opinion that the actuary should advise and enlighten corporate management to allow sufficiently liberal early retirement rights to give management the flexibility to replace employees whose skills have become obsolete while allowing those employees to have a secure and reasonably adequate income upon early retirement. Benefits should be secured by adequate funding, not merely because of standards imposed by federal and state legislative bodies but also to reflect the actuary's best judgment with regard to the continuing viability of the industry in which the employees work. Only if the benefits are secure for retirees will the social security pension, which the retirees depend upon, be able to provide an adequate foundation for sufficient retirement

income—eliminating the necessity for the employee to work after retirement, with a consequent loss or reduction of his social security benefits. In other words, an adequately designed and funded pension plan helps the employer to have the flexibility to replace older employees without reducing their standard of living; it helps the employee to be assured of receiving his full social security benefits for which he has paid and worked during his career; and it helps the public by eliminating the possibility of retirees going on the welfare rolls.

Even if a pension plan is adequately designed and funded to the satisfaction of management, a great deal of the value of the program is lost if the program is not adequately communicated to the employees. In my opinion, this is an area where actuaries have rarely measured up to their responsibility. The average pension plan document is a long, dry document with page after page of technical terms; most of these terms are inserted to fulfill legal requirements. We must remember that most plan participants are not actuaries or lawyers and cannot comprehend their retirement rights from reading a pension plan. Surely a booklet which describes the plan in simple words or in a series of questions and answers or even in graphic illustrations is much more instructive to the employee and will provide a valuable personnel relations tool for management. However, of greater value are individual statements for employees—for example, annual statements of benefits accrued under the plan or, preferably, periodic presentations by management or by the actuary describing the benefits provided under the plan. I think that communicating pension plan information to plan participants and management in an easily understandable manner not only will result in a happier client but also will serve as an effective form of advertising for the actuarial profession itself and remove the stigma associated with most actuaries, namely, that they cannot communicate to the "outside world"—the world of nonactuaries.

As regards the public, each qualified private pension plan can be considered to be a fund which has been granted a special federal and state tax shelter. In this light, the contributions paid by the employer and the investment income earned by the pension fund in effect divert tax dollars from public to private use. Consequently, the actuary's responsibility should be such that the amount of funds diverted and placed in this tax shelter is the maximum amount necessary to meet all the security requirements of the employees yet is not so great that the employer can manipulate his taxable earnings in any manner.

Another aspect of the responsibility of the pension actuary to the public applies to the area of actuarial advice provided to state and

municipal plans. Because of the immense pressures which may be placed on state and city governments to provide ever improved retirement plans for public employees, it is my opinion that the actuary has a great responsibility to advise government agencies as to how the benefit rights and the levels of benefits of public employees compare with similarly compensated employees in private industry. Not only does the actuary have the responsibility to ensure the adequate design and funding of programs and to provide the explanation of his views as to how these programs compare with private plans; he also has a profound responsibility to inform public agencies of the prospective long-term impact on the tax revenue of the various provisions which may be incorporated into public plans. One example is the inherent cost of the popular "cost-of-living" adjustment to the pensions of employees who retire under public systems. The public should be well aware of the enormous increase in actuarial liabilities necessary to properly fund such benefit improvements and, consequently, of necessary tax increases to support them. In the area of statewide pension plans which use a final salary formula and which also incorporate "portability provisions," the actuary should apprise the public as to the potential cost impact on a city or other governmental entity, since its pension costs can be increased several fold because of the changes in salaries of former employees who remain in public service but move from city to city or from one governmental agency to another without incurring any break in service—nevertheless generating additional costs for the city or agency where they were formerly employed.

Another area where the actuary has a responsibility concerns the government-imposed perpetuity known as the social security pension system. This is an area in which the public is very confused and in which politicians have long worked diligently for political gain. It seems to me that the actuary owes it to the public to find forums to inform the public of how the long-term cost of the program could be reduced *if* the plan were adequately funded under the same conditions as private pension plans, where investments could be made in private industry—making capital available for consumer use in creating substantial pension fund assets which ultimately would pay a great share of the cost of the program. To the extent that the funds are invested in government securities, the investment income on those securities is merely additional money which has to be raised by other federal taxes and which creates a different source of revenue for the social security system. Currently, the social security system is structured on a pay-as-you-go basis and is intended to remain essentially in that form, according to actuarial pro-

jections. However, without the leveraging effect that investment earnings can have on long-term pension costs, the foundation of the social security system can be seriously damaged if the population of the country stabilizes and/or begins to decline. In the latter instance, substantially increased contributions will be required or additional taxes from general revenues will have to be raised—seriously damaging the public confidence in the social security system. It is in these areas that actuaries should begin to speak out and be ***heard and understood,*** since actuaries are the only technical experts with proficiency in making long-term projections and analyses involving the contingencies of death, disability, retirement, and the myriad other factors that affect the adequate funding of pension benefits.

MR. HOWARD YOUNG: Dan McGinn's statement that the cost of social security benefits could be reduced by prefunding, and by investment in private industry, is subject to many questions. First, in order to prefund, the cost would have to be substantially increased for some initial period, and that period could last for many years. Second, the investment of large amounts of public trust funds in private industry would introduce a significant modification of the concept of "private" industry. Third, merely shifting a portion of the ultimate income from "taxes" to "interest and dividends" would not necessarily change the cost of the program to the over-all national economy (even though it would affect the allocation of that cost among individuals and businesses); the purchasing power provided, in any year, to beneficiaries would have to be met by the goods and services available in *that* year. *If* the prefunding resulted in increases in total national investment and then increases in productivity, then total goods and services available in future years ***might*** be greater than otherwise. But there is no assurance that would happen, or even be desirable (for insurance, what are the ecological consequences?), since the prefunding might result in a decrease in other forms of national savings or investment. In fact, if it reduced consumption levels it might serve as a disincentive for businessmen to invest and hence reduce total resources. The issue is one of macroeconomic theory, not of actuarial science; the results of national fiscal activities are not necessarily analogous to those of any single business or subgroup in the economy.

MR. RICHARD DASKAIS: I am going to discuss our subject from the standpoint of the consulting actuary whose clients are primarily employers. Stated very simply, I believe that there are no absolute re-

quirements as to the assumptions and methods that should be used in valuing or costing a pension plan.

Opinion S-4 points out that, because of his responsibilities in the pension field, the actuary should give consideration to the following:

1. Careful interpretation of his client's objectives in terms of plan design, benefit security, and financing.
2. Explanation of the available alternatives and their effect upon these objectives.
3. Translation of the plan objectives into the type or types of valuations to be performed.
4. Appropriate assumptions and cost methods.

The Opinion also states that the actuary should adequately and clearly disclose pertinent facts and findings in actuarial reports.

The Opinion lists items which the actuary should consider. However, the choice of assumptions and methods which are appropriate to the client's objectives is left to the actuary's professional judgment.

The consulting actuary's responsibility is to his client. I believe that he is responsible only to his client, with one important qualification. That qualification is that the client cannot misrepresent the work of the actuary to trust parties. There are certain constraints on the pension actuary's choice of assumptions and methods that follow from this qualification, but I do not believe that these constraints result from any direct responsibility of the actuary to represent the interest of persons other than his client.

In pension plans supported by employer contributions, there is an inherent conflict between the interest of the employer and the interests of employees covered by the plan. I believe that it is impossible for the actuary whose client is the employer to represent the interest of the employees. If the client is a corporate employer, the actuary should consider himself ultimately responsible to the shareholders.

I have not been able to find any responsibility of the pension actuary to the general public, other than responsibility to those parts of the public which are employees or shareholders.

Our area of expertise involves the calculation of the present values of the benefits to be provided under a pension plan. Our expertise also includes the design of various schemes relating to the incidence of cost or contributions so that the actuarial present value of these costs or contributions is equal to the actuarial present value of the benefits. I do not think that there is anything sacred about using a scheme of cost or contributions that is level, or calculating the present value of benefits

on a conservative basis, as long as there is no representation or implication that the costs are level or that values have been computed conservatively.

We must recognize the environment in which we operate. Users of actuarially calculated costs may reasonably expect the costs to be level and expect them to be computed conservatively. This has been the common practice among actuaries. This does not mean that level, conservative costs necessarily are more useful or more desirable. This means that an unqualified statement by an actuary as to a cost is reasonably interpreted by the reader as referring to a level, conservative cost. If the actuary or his client believes that it is appropriate in a particular situation to use a nonlevel cost or a cost which is not calculated conservatively, this must be clearly spelled out.

My own preference in choosing assumptions is to use what I believe will be realistic assumptions in those areas where the client can be expected to rely upon the actuary's expertise, such as mortality, withdrawals, and perhaps retirement rates. Conservatism or lack of conservatism should be reflected in those assumptions in which the client can be expected to be as knowledgeable as the actuary, such as the interest rate and pay increase rate. In addition, it is helpful to provide the client some quantitative estimate as to the sensitivity of costs to the use of different values for the unrealistic assumptions.

A typical client may not recognize that pension costs based upon 6 per cent interest and the Northampton table are not very conservative, even if the Northampton table is fully described in a technical appendix to an actuarial report. However, the same client may be expected to recognize the character of pension costs based upon 10 per cent interest and a modern group annuity mortality table.

The primary objective of an actuarial report is that it be understandable to the reader. If the reader of the report cannot be expected to understand it because it is full of technical jargon and various caveats, then it is of little value. The report should be understandable to the reader for whom it is prepared and relevant to the purpose for which it is prepared. Reports should not, in my opinion, be prepared with any significant concern for possible review by another actuary.

I think the device of a technical appendix is useful. The body of the report should state those findings of the actuary in which the reader can be expected to be most interested. The body of the report should also contain any important qualifications which the actuary deems appropriate for the purpose. The qualifications should not be buried in the technical appendix.

Very frequently the person who receives an actuarial report makes his own further report to others. For example, the benefits manager of a large company may wish to pass the substance of an actuarial report on to top management. If the report is long and technical, the benefits manager will paraphrase it. On the other hand, if the report is brief and readable, the benefits manager may pass it on verbatim. I think that the actuary's findings are less likely to be distorted (intentionally or unintentionally) if the report is brief and readable.

I also believe that the practice of submitting long reports tends to encourage the preparation of reports on a routine basis by personnel who are not as experienced or as well qualified technically as the actuary responsible for the report. I believe that this leads to lower-quality actuarial work.

I believe that Opinion S-4 is a good guide as to what should be in an actuarial report. The opinion enumerates items to be considered, which include the purpose which the report is intended to serve; a reference to the plan; the effective date of the valuation and the date and sources of data; a summary of the statistics pertaining to the group; a summary of the basic valuation results; and a statement of the actuarial assumptions and methods, including, where appropriate, an appraisal of their suitability.

My experience has been that important actions are often taken by an actuary's clients even though they have had relatively little time to review a comprehensive formal actuarial report. A good example of this is in labor negotiations. Very infrequently will the employer-client have the opportunity to read a long actuarial report providing among other things the cost of benefits that have been contained in the last union proposal to which the employer must respond. Sometimes the "actuarial report" upon which the client acts consists of a series of numbers read over the telephone or worked out in a caucus room. In such cases, it is important to have established, through previous actuarial reports and discussions, an understanding on the part of the client of the assumptions and methods upon which costs will be based.

If costs are to be discussed with the union, the company may not wish to present a formal actuarial report along with costs. The actuary's responsibility is to make sure that his client does not misrepresent his numbers. Usually the company defines the increase in cost associated with an increase in benefits as the expected increase in contributions attributable to the increase in benefits. The increase in cost usually will be calculated on the basis of the actuarial assumptions and methods

which have been publicly reported under the federal disclosure act and may have been directly reported to the union. If this is the situation, I believe the actuary has no responsibility to volunteer any comment upon the actuarial assumptions and methods. However, the employer should identify the actuary who is responsible for the calculations. The actuary should be available to describe to the union or the union's actuary what has been done and provide sufficient commentary so that the union can evaluate properly costs presented by the employer.

Most of you are aware that section 104 of H.R. 2 as passed by the House of Representatives will require the filing of a complete copy of an actuarial report for each pension plan subject to the act. The report includes minimum contributions, normal costs, accrued liabilities, and present values of accrued nonforfeitable benefits. The actuary must be engaged by the plan's administrator, "on behalf of all plan participants." The bill appears to require the actuary to report his opinion as to whether the figures reported are reasonably related to the experience of the plan and to reasonable expectations and are based upon assumptions which, in combination, offer the actuary's single best estimate of anticipated experience under the plan. This would appear to leave the actuary no flexibility in assumptions, since it is hardly likely that an administrator will want to file a report which states that the assumptions are not reasonably related to the experience and reasonable expectations or are not based upon assumptions which offer the actuary's single best estimate of anticipated experience.

The actuary who prepares such a report will be responsible to the plan participants under the bill. If the actuary believes, as I do, that he cannot represent both the participants and the employer, there will have to be two actuaries for most pension plans—one for the participants and one for the employer. This will result in some duplication of actuarial work. What we think of now as the "regular actuary" for the plan will probably be the participants' actuary, since the bill requires him to supervise most of the computations. However, the bill appears to prevent the participants' actuary from fully representing them. Their interest might sometimes be associated with conservative assumptions, and sometimes with optimistic assumptions, rather than with the realistic assumptions called for by the bill. Their interest might also be better represented by the use of nonlevel cost methods.

The problem is quite different from the possible conflict faced by public accountants between the interests of management and the interests of shareholders. Management is in turn responsible to shareholders, so

there are not two parties to whom the public accountant is ultimately responsible; there are, however, two distinct parties of interest in a typical pension plan.

Passage of the bill may test our ability to produce and to enforce professional conduct guides which protect the participants and the employers. I believe that much of the public has thought of the actuary as an impartial technician who need not represent either the employer or the participants. If the bill becomes law, I hope the profession will recognize the conflict between the participants' interest and the employer's interest.

MR. CARL VOSS: I wish to comment on the one piece of legislation that I feel should concern all of us as actuaries, since it could take away some of our responsibility. As I see it, we may have standard funding assumptions and funding methods imposed on us if plan termination reinsurance is passed by Congress. They could be imposed directly by the federal government through a set of minimum and maximum funding assumptions.

On the other hand, standards could be imposed indirectly, in that there would have to be a premium based on the "unfunded" liability in addition to the per life or per plan premium for the plan termination reinsurance. The liability would probably have to be measured on a standard set of assumptions using a standard funding method in order to maintain equity between employers. Thus employers in the future may want to use these assumptions in funding their plans or at least keep them in mind in order to keep down their reinsurance premium. They may also want to fund their plans more quickly in order to reduce their reinsurance costs.

Montreal Regional Meeting

CHAIRMAN GEORGE W. POZNANSKI: This discussion will cover three main topics from three different points of view.

For example, should the actuarial profession promulgate absolute requirements concerning the elements that enter into the valuation or costing of pension plans and require actuaries to adhere to these standards? Should actuaries accept absolute requirements imposed upon them by another profession, such as, for example, accountants? Should absolute requirements be prescribed by legislation in general, or for certain purposes only—for example, solvency of pension plans for legislative purposes and evaluation of unfunded liabilities for purposes of re-

insurance? With the legislative proposals in the United States and with the experience under the Canadian pension benefits legislation, a discussion of these topics is very pertinent.

MR. WILLIAM A. DREHER: I shall approach this discussion from the point of view of a United States consulting actuary, one who has served on the Society's Committee on Retirement Plans.

I. ABSOLUTE REQUIREMENTS

Should actuaries be required to employ prescribed methods and assumptions in determining the costs and liabilities of pension plans? Anyone who has sympathized with the struggles of laymen attempting to understand pension funding concepts or to compare the pension costs of one organization with another is tempted to say yes. But, unfortunately, a conscientious defense of this proposition must fail. The failure is due to the simple fact that the actuary's computations are only a silhouette of a future reality. Neither that reality nor the actuary's present perception of it will be identical or even necessarily similar from one pension plan to another.

For approximately ten years the Society and its sister organizations have been trying to define acceptable actuarial principles and practices for pension plans. Those of us who have participated in these efforts or watched from the sidelines have been first expectant, then disappointed. At times it has seemed impossible to agree on anything. The net result has been abandoned drafts, incomplete agendas, frustration for the participants, and cries of abdication of responsibility from legislators, the accounting profession, and other members of the public.

I believe that our difficulties stem from a silent false assumption. We have assumed that the costs of pension plans providing similar levels of benefits to employees with similar demographic characteristics will be identical or nearly so. Our attention has been concentrated on the effort to define and narrow the range of acceptable actuarial standards for assigning a present value to a plan's future obligations. Relying on the unspoken assumption that the actuarial process focuses on a singular target for all similar plans, we have attempted to seek solutions to the problem of identifying an approved set of actuarial standards that are too tight and narrow.

When the actuaries who are assigned these tasks have been unable to agree, many have concluded that their difficulties arose from professional vanity and an egotistical desire to avoid having one person's judgment subject to another's review. I would be the last to deny that actuaries

are a stubborn lot. We have too great an inclination to prefer abstract argument to practical compromise, but we should look for a deeper explanation before concluding that our profession is incapable of defining the standards to be used in educating actuaries, guiding our daily affairs, and informing the public.

To support my claim that the long-term cost of similar pension plans can differ widely, consider these facts:

1. Mortality studies of medically underwritten lives show that the range of large-company experience is about 30 per cent of the industry average. Studies of group annuity mortality and the mortality under self-administered retirement plans show even wider variations.

2. Pension fund investment returns, even when averaged over long time periods, show substantial variations from one pool of assets to another. For example, our firm's latest investment performance survey includes a nine-year performance history for fifty-six pooled equity accounts managed by United States banks and insurance companies. During these nine years, the Dow Jones Industrial Average, including dividends, showed a total annual return of 3.36 per cent. The range of annualized total investment return for the fifty-six funds was from −1 to +7 per cent. The same type of variation exists among pools of fixed-income assets. A nine-year total annual return on thirty-six United States bank fixed-income funds ranged from 0 to +5 per cent.

3. Rates of retirement are affected significantly by the existence of other benefit plans sponsored by the employer, the provisions of the social security law, and the current rate of inflation.

Let me offer one pragmatic demonstration of the variations in pension costs among similar companies. Last year we surveyed the pension costs of thirteen major oil companies, all with generally similar benefits and fairly mature work forces. Their 1972 pension costs ranged from 1 per cent of payroll to 14 per cent of payroll. Some of this variation was due to the actuarial methods and assumptions underlying the pension cost calculations, but part was also due to historical and probable future differences in the financial and actuarial experience of the various plans.

Here is a simple illustration of the combined effect of variations in true costs and variations in the actuary's assumptions about a plan's future. Let us assume that the pension cost independently determined by several competent actuaries for a single plan will fall within a range having outer limits that are one-third above and one-third below the average of their separate opinions. If this is the case, the apparent cost of this plan may, at the extreme, be determined by one actuary to be double the cost developed by another. If we now consider that the true cost of similar plans covering comparable sets of participants may differ

from the true cost of the whole group of plans by as much as one-third, the apparent cost of any two plans may differ from one another by a factor of 4. Half of this variation in apparent annual costs is introduced by the opinions of actuaries about the uncertain future of the funds. The other half is introduced by objective differences, some of which are attributable to the past life of the pension funds, while the remainder await the judgment of time. I would agree that this display gives only slight comfort to users of actuarial services or the readers of actuarial reports, but it may help us to gain perspective about the nature of the problem we face.

We must attempt to narrow the range of acceptable actuarial practices, but we must also make strenuous efforts to gather and display the facts about pension plans' financial operations and we must show more respect for the probabilistic character of the future. We are so used to making point estimates of pension plan costs and liabilities that we lose sight of the fact that any single actuarial valuation represents only one value in a frequency distribution of possible end results. Our efforts to simplify a complex process, however well intentioned, have contributed to a massive confusion of the public and, I would submit, have diverted the attention of actuaries away from an important area of professional research and statistical analysis.

II. WHAT SHOULD BE INCLUDED IN A GOOD ACTUARIAL REPORT?

The actuarial profession in the United States is failing its responsibility to its members and the public by not developing, communicating, and enforcing generally accepted principles and practices in connection with pension plans. I speak as one who shares the responsibility for that failure. Correcting this deficiency must be a critical priority for the coming years. We can succeed if we are determined to do so. The work being done by the Academy's committee on this topic, which is ably chaired by George Swick, gives encouraging signs of progress. The task is quite enormous, and I think we must be prepared for further delays and difficulties before this great need is satisfied. Without a paid professional staff to do research and prepare exposure drafts, the labor must come from the voluntary efforts of practicing actuaries, and, in competition with business and family responsibilities, the demands of professional committees usually take a poor third place.

Despite our past problems and probable future difficulties, it is important to keep this issue in perspective. I find both instruction and comfort in the history of the accounting profession in the United States. Until the passage of the Securities Act of 1933, which established the

Securities and Exchange Commission and gave it power to prescribe the accounting principles that must be followed by industrial corporations whose securities are registered with it, there was very little formal codification of accounting principles and auditing practices. The infant SEC indicated that it would rely on the accounting profession to identify those principles and practices, but the immediate results were slight and did not prevent the McKesson and Robbins scandal of 1938. Those of you with an interest in financial history will recall that the assets of McKesson and Robbins were grossly inflated because inventories were falsely stated through an elaborate scheme involving fake purchase orders, warehouse receipts, and other documents. The auditors did not check physically the inventory or confirm independently the company's receivables. Following the collapse of the company, an investigation by the New York Stock Exchange determined that auditing practices were grossly deficient and gave the accounting profession a fresh incentive to upgrade the standards and practices followed by its members.

However, progress continued to be slow, and in 1959 the profession established the Accounting Principles Board as a vehicle for concentrating the energies of the profession and achieving results. This decision was substantially affected by demands from the SEC that the accounting profession move more vigorously to discharge its duties; the SEC threatened to step in and establish new standards by fiat if it did not do so. The Accounting Principles Board, which was composed entirely of accountants, did make substantial strides, but by the late 1960's there was increasing evidence that accountants working together were still unable to resolve disputes on many substantial issues or were willing to permit a wide variety of alternative practices with respect to some accounting principles, thereby allowing important differences in the financial reporting of similar companies, encouraging improper reporting by less than honorable managements, and causing considerable confusion in the minds of the investing public.

Recognizing these difficulties, a study commission composed of practicing accountants, corporate finance officers, business school professors, and other members of the public was appointed in 1970. As a result of this investigation, a new entity, the Financial Accounting Standards Board, was established in 1972. The FASB is financed by assessments against the accounting firms but is wholly independent of the accounting profession in its operations and includes public as well as professional members. Its current budget exceeds $3 million.

From this forty-year history, I draw several conclusions. The systematic development of accounting principles and auditing practices re-

quired first a federal law and then a widely publicized scandal. The progress of professional committees operating on a part-time basis was limited and unsatisfactory. An independent board operating with a substantial budget and a paid professional staff made meaningful progress, but ultimately the best interests of the profession and the public were deemed to require formal direct involvement by representatives of the public and a far larger financial commitment. I hope that actuaries will profit from the experience of the accounting profession.

Canada has had a federal pension law for a number of years, and obviously it has affected the development of professional standards. In the United States we soon will have a federal law containing significant new requirements for reporting and disclosure of actuarial and financial information about pension plans. The law probably will give federal agencies the power to define reasonable actuarial assumptions and acceptable actuarial practices for pension plan valuations. I welcome this development, since I doubt that we would take collective action without this goad. Let us hope that we do not need a public scandal, or criminal indictments of actuaries, in order to push our profession toward the full discharge of its obligations.

In going forward, we always must keep in mind our paramount duty to the public, including not only the clients who pay our fees but the plan participants whose future prosperity is affected by our work, the shareholders who have approved the plans, and the customers and taxpayers who are the source of funds to meet their obligations.

III. THE ACTUARY'S RESPONSIBILITIES

I would like to make one final point about our relationship with the public. Our profession has stressed the personal responsibility each of us bears for his actions. We should never lose that sense of individual duty to the profession and the public, but the implementation of this abstract concept is inconsistent with the realities of the business world. Almost all of us are employees, either of insurance companies or of incorporated consulting organizations. Only a handful of our members operate as sole practitioners or in partnerships composed only of actuaries. Yet our Guides to Professional Conduct seem to ignore the fact that the clients who retain our services and the employees who participate in the pension plans we serve are relying primarily on a firm for actuarial advice, not on the individual actuary who supervises the calculations or offers the specific actuarial recommendations. The continuing business relationships are with the firms. The firms are hired and the firms are paid. If problems justifying legal action arise, it is the firms which will be

sued. Only if criminal indictments were issued would individual actuaries bear the primary burden. It is important to establish more clearly than we have that firms providing actuarial services not only must be legally accountable in the event that their advice or actions cause damage to an affected party but also must assure themselves and their clients that the actuaries employed by those firms, regardless of their internal authority or ownership, are providing consistent advice under similar circumstances.

I think it is unrealistic to expect individual firms voluntarily to allocate their time and resources to defining professional policies and monitoring their application. A more practical answer might be to establish a research foundation under the auspices of the professional societies, with financial support coming from the consulting firms and cooperating insurance companies in the group annuity business. This foundation would be responsible for developing professional standards, gathering data about current practices and trends, and communicating suitable information to the public. If consulting firms would agree to contribute one-half of 1 per cent of their annual employee benefit revenues and insurance companies would agree to pay a similar percentage of their expense loading on group annuity premiums, we could operate such an organization with an annual budget of at least $500,000. I would like to propose that the feasibility of this idea be investigated jointly by the Canadian Institute and American Academy, since many of the benefits to be derived would cross national boundaries. I will also commit my firm's financial support to this undertaking.

MR. JOHN G. IRELAND: I wish to approach our subject from the point of view of the situation in Canada, presenting my thoughts as a professional practicing in Canada. I will also express some thoughts of the profession as they are being developed within the Canadian Institute of Actuaries Committee in Private Pensions.

I. ABSOLUTE REQUIREMENTS

In Canada there are three types of legislation which have a pervasive effect on the design and funding of pension plans. The income tax acts of Canada and the Province of Quebec provide similarly for the tax deductibility of employer and employee contributions to pension plans. Essentially they say that an employer may deduct contributions in respect of payments made for current service benefit accruals, and for special payments made on account of "past services of employees," which is another way of designating special payments made toward

liquidation of unfunded actuarial liabilities. This second category of payments, in order to be deductible, must be approved by the minister of national revenue on the advice of the superintendent of insurance, pursuant to a recommendation by a Fellow of the Canadian Institute of Actuaries.

In this process the role of the Department of Insurance is to judge the appropriateness of the actuarial valuation methods and assumptions used to determine the unfunded actuarial liability as well as the accuracy of the arithmetic. Thus, actuaries in the Department of Insurance review valuation reports and the associated working papers to satisfy themselves that the unfunded actuarial liability is correct and reasonable. To all intents and purposes, the Department of Finance of the Province of Quebec relies on the approvals of Revenue Canada for its corresponding purposes. Another type of legislation, which has a less direct and obvious effect on the consulting actuary, comprises the Old Age Security Act, the Canada Pension Plan, and the Quebec Pension Plan. The last two, except for a brief departure during 1973, have substantially identical benefit and contribution provisions.

Most pension plans in Canada are of the contributory unit benefit type. They are contributory partly for historical reasons and partly because employee contributions to registered pension plans are deductible to the employees in determining their taxable income. They are of the unit benefit type because unit benefit plans seem to produce the best results. Typically, also, they are formula-integrated; that is, the benefit credit rate and the employee contribution rate on earnings up to the Canada or Quebec Pension Plan tax limit are lower than they are on excess earnings. Generally, no account is taken of old age security benefits in pension plan design.

These are generalizations to which there are a multitude of exceptions. Noncontributory pattern plans exist for auto workers, electrical workers, rubber workers, and many other unionized groups.

Another important class of plans provides for the offsetting of all or a part of Canada and Quebec Pension Plan benefits and, often, employee contributions. When the Canada and Quebec pension plans were first introduced, the benefits built up percentagewise on a straight line from January 1, 1966, to January 1, 1976. In the early years of the plans those retiring under the system received substantial windfall benefits as compared with the value of their contributions. Recently, plan amendments have been contemplated, which undoubtedly will come into effect, providing for an incerase in the tax base at the rate of $12\frac{1}{2}$ per cent per annum until it catches up with a composite industrial wage index. Con-

ventional wisdom has it that this catch-up will have taken place by the year 1980, after which the tax base will parallel the composite wage index. This will have the effect of compounding the windfall effect built into the plans originally.

The third category of legislation is that which most affects the consulting actuary. For want of a better term, I shall refer to it as "pension benefits" legislation. Laws in this category have been enacted in Alberta, Saskatchewan, Ontario, and Quebec and by the federal government to apply to pension plans organized and administered for the benefit of persons employed in connection with certain federal works, undertakings, and business. These include the railroads, airlines, banks, radio broadcasting stations, and so on.

Many of you, I am sure, are aware of the provisions of these laws, but I shall enumerate the salient ones. First, there is no requirement that any employer *have* a pension plan for his employees. If, however, he chooses to have one, then, to the extent that it covers employees in any of the affected jurisdictions, it must comply with the provisions of the appropriate act with respect to mandatory plan provisions and funding. The most prominent of the mandatory provisions is that requiring the vesting of benefits accruing since the qualification date of the act in question on termination of employment after attainment of age 45 and completion of ten years of continuous employment with the employer. The period of continuous employment includes employment prior to the qualification date.

Briefly, the funding requirements are that unfunded actuarial liabilities which existed at the qualification date of the act, or those which are subsequently created by liberalization of the plan, must be liquidated by special annual payments at least sufficient to accomplish the liquidation within the twenty-five-year period following the qualification date of the act, or within fifteen years following the establishment or liberalization of the plan, whichever period is the longer. The acts also provide for triennial actuarial valuations. Where such valuations indicate that an experience deficiency has developed in the intervaluation period, such deficiency must be liquidated within five years of its discovery. The philosophy underlying this legislation is clearly that, while employers need not make pension promises, if they do, they must set about delivering on such promises.

Perhaps because our population and economy are about one-tenth the size of our cousins to the south, the administration of all the laws which impinge on pension plans and funding has been efficient and easy. The regulators and "regulatees" seem to operate in an atmosphere of mutual

trust. It is always possible to pick up the telephone and talk to the authority. Discussion of problems is easy to arrange and often takes place on a first-name basis between qualified actuaries.

The Private Pensions Committee of the Canadian Institute of Actuaries plays an important role in the process of communication between employers and the government in regard to pension matters. The committee recently evolved a certificate format which it hopes will be appropriate for certifying both to unfunded actuarial liabilities and experience deficiencies under pension benefits legislation and to unfunded actuarial liabilities for income tax purposes. In this process representatives of the committee met to discuss the certificate design with interested actuaries representing the Quebec Pension Board, the Pension Commission of Ontario, and the Department of Insurance of Canada.

One interesting problem which arose in the process of designing the certificate was the question of whether or not it would be proper for an actuary to certify to one set of figures for purposes of the income tax act and another set for purposes of, say, the supplemental pension plans act of Quebec. You can imagine a situation in which an employer, conservative in his attitudes toward pension funding, might adopt a budgeting plan for pension costs on an entry age level basis with conservative actuarial assumptions. He may, however, at the same time decide that for purposes of the pension benefits legislation he should not commit himself to so conservative a funding pace. Accordingly, he might ask his actuary whether it would be possible to certify funding requirements in accordance with less conservative standards for pension benefits legislation purposes and, at the same time, in accordance with the conservative basis to Revenue Canada. In this way, given the ability to pay, he has a device through which he can make contributions to his fund, and take tax deduction for them, that are much higher than are required by the pension benefits law and at the same time not be committed to making such contributions year after year. I think it is fair to say that the consensus of the committee is that to provide two such certificates is not proper. One certificate at any one time is the committee's credo.

With nearly ten years of administration of pension benefits legislation in Canada, we have encountered quite a few of the problems. Perhaps one of the thorniest is that faced by the regulators in drawing the line between adequate and inadequate funding standards applied in actuarial valuations. Their responsibility is to protect the beneficiaries of pension plans. They have the right to refuse to accept any report which they deem to be based on inadequate standards.

In considering this issue, extended discussions have taken place be-

tween the regulators and the profession in Canada, and the question of minimum valuation standards naturally has received consideration. So far, I am happy to report, the idea of minimum standards has been rejected in favor of effectively relying on the profession to police itself, and upon certificate wording which essentially puts responsibility squarely on the actuary himself. I personally can see no useful purpose served by having absolute requirements for valuations other than to protect certain pension plan beneficiaries from weak or unscrupulous actuaries. I believe that the number of such actuaries is so small as to be insignificant. The pension benefits laws because of their very existence have been seen to have the effect of inhibiting some employers from liberalizing or adopting pension plans. If there were also absolute valuation standards, this effect would be magnified. There is also, of course, the question of who should establish the criteria for any absolute standards, and, while the rulebooks are already getting thick enough so that the consulting actuary's livelihood seems to be assured, I would hate to think of coping with a whole new body of technical regulations which would be incomprehensible to all but the very expert.

We are attempting currently to devise a system whereby controversial actuarial reports can be reviewed by the Canadian Institute of Actuaries committee. So far no very difficult problems have arisen, although there have been inklings of differences of opinion between actuaries—perfectly honest differences—which may, in due course, require some formal sort of adjudication. We have at this moment, incidentally, certain conflicts between the various authorities charged with the regulation of the pension benefits legislation and the income tax act. One or two examples will illustrate:

1. Under final pay pension plans, it is sound funding practice to anticipate future salary increases related not only to increased prospective productivity and advancement in the organization but also to the inflationary increases in general wage levels. The pension benefits authorities should require that recognition be given to prospective wage inflation for sound funding. Revenue Canada, however, has a different interest, in that such anticipation of inflationary wage increases produces substantially larger liabilities (and deductible employer contributions) than if they were not anticipated. The current position of Revenue Canada is that advance funding for this factor is not permitted. This, of course, creates a propensity on the part of the consulting actuary to be conservative with respect to other assumptions if he cannot take this one into account.

2. Similarly, many pension plans are providing for the indexing of pensions once they commence, such indexing typically being with some function of the

consumer price index. These increases also fall into the category of not being allowed to be funded in advance for tax purposes but having to be funded for purposes of pension benefits law.

II. WHAT SHOULD BE INCLUDED IN A GOOD ACTUARIAL REPORT?

Concerning the contents of a valuation report, I believe it should contain sufficient information to indicate that the data are reliable and complete and that adequate checks were placed on the data to assure their correspondence with the facts. It should also, of course, contain a statement of the actuarial assumptions and the funding method, together with a certification that these are, in the opinion of the actuary, adequate, appropriate, and in compliance with sound actuarial principles as provided for in the Guides to Professional Conduct.

Before leaving the valuation report, I should like to comment upon one aspect of the valuation which seems to me often to receive less attention than it should, and that is the valuation of assets. In pension fund administration it is only in the most exceptional of circumstances that any distinction should be made between realized and unrealized capital gains or losses. It seems to me, therefore, that what has heretofore been the orthodox method of valuing assets in a pension fund balance sheet—namely, at cost—is inappropriate. Market values seem equally inappropriate. A number of "actuarial" methods have been developed which should, in my opinion, be used, and the valuation reports should contain as detailed descriptions of the methods of valuation of assets as they do of the methods of valuation of liabilities.

III. THE ACTUARY'S RESPONSIBILITIES

In the valuation of pension plans the actuary is responsible to a number of entities, the first of which, I suppose, is himself. Next to himself, he must recognize his responsibility to the beneficiaries of the plan as implied by the pension benefits legislation. The actuary in this context must be satisfied that, in his opinion, the funding pattern contemplated is a sound one for the plan in question in its present condition. He also, of course, has a responsibility to his client to establish a funding pace which best suits the client's requirements, provided that such satisfaction does not compromise the soundness of the program from the participants' viewpoint.

There is always a spectrum of acceptable possibilities for funding any pension plan. Theoretically, the approaches can vary from pay-as-you-go to the setting aside of lump sums at the time an employee is hired, and a particular funding method is merely a definition of where,

within these limits, that method falls. We have evolved "orthodox" funding methods—unit credit cost, entry age level, attained age, fixed initial liability, and many others. There is nothing magical about any of these, but there can always be established a range of acceptable possibilities, considerably narrower than the outside limits, which can be regarded by the actuary as being sound in the light of his responsibilities. Within this range I believe he is free to choose what best suits his client. If the actuary takes care of his three basic responsibilities, he will have done his job, but his report must tell more of a story than the traditional actuarial report has done in the past. The old concept of providing a snapshot assessment based on data supplied by the employer, applying traditional methods and conservative assumptions, is passé. Reconciliations of data should be made and sources of gains and losses analyzed; assumptions should be conservatively realistic and the method appropriate.

The pension benefits legislation creates a propensity for the actuary to use realistic assumptions and methods. If the actuary errs on the side of being not conservative enough, he risks presenting his client with a surprising experience deficiency at the next valuation which has to be funded over the ensuing five years. On the other hand, the establishment of initial unfunded liabilities according to overly conservative standards creates a long-term commitment for the employer which may be unnecessarily onerous.

Fortunately, we now have tools which enable us to communicate to our clients the implications of what is being done. Because of our ability to process mountains of arithmetic quite economically, we can write a number of "what-if" scenarios to minimize the surprise element of each valuation as it emerges. In this connection, it is important to emphasize that the calculations made to fill in the scenario blanks should not be interpreted as being necessarily alternative possibilities for determining pension costs but rather as illustrations.

There are other situations wherein valuations are done using standards different from those applicable for cost purposes which, at the same time, are entirely appropriate for their purposes. One obvious example is the case in which an employer is negotiating a new collective bargaining agreement and the negotiations include provision for improving pensions. Determining the value of the improvement is critical, or should be, in the negotiating process. What the employer chooses to set aside when finally the improvement is in effect is the employer's business. He and his actuary should decide on how to budget for the cost of the improvement.

MR. D'ALTON S. RUDD: I shall approach our subject from the point of view of a professional who is a company actuary and not subject to the same influences as consulting actuaries. I will also discuss some aspects of our subject from the point of view of an actuary associated with a Canadian regulatory authority.

I. ABSOLUTE REQUIREMENTS

Let us face it and be honest—there is a natural tendency for the regulator to like precise and exact definitions so that he can have everything laid down in columns and tables that a clerk can use for checking purposes. That has not been, however, the Canadian tradition. We have been, in our life insurance, a halfway house between the British system where the actuary signs both sides of the statement and the American system where he seems to be an internal man who has his valuation bases prescribed from outside. Also, as a practical problem, there is just no way that we could regulate the eight thousand or so group pension plans in Ontario in the way that life insurance is regulated in the United States with detailed rules and so on. So we took the attitude in Ontario, and subsequently so did the other provinces and the federal government, that the responsibility would lie with the profession.

Also, absolute requirements fail to recognize the over-all picture. If you tie down the interest rate, for example, you have to start tying down everything else. You have to specify the asset valuation, the early retirement situation (i.e., how it should be handled), the salary scale, and so on. It becomes a very difficult approach. It is also liable to suggest the implication that there is a safe minimum valuation liability or reserve, whatever you want to call it, for that plan.

One of the problems of our legislation which leads to confusion is that, in effect, we indirectly have a solvency test, because our definition of a plan's being "fully funded" is basically a unit credit definition. So everybody closes his eyes to the fact that an actuary may want to use the entry age normal cost method. On a plan with no past service this method produces an accrued liability because of the nature of the method. That liability is treated as if it were a past-service liability, and the plan is not "fully funded" until that liability is paid off. These are semantics that we all ignore. This is one of the things that make it difficult to define a basis and actually use it as a solvency test. Instead, we depend on a section of our regulations which defines what is to be included in an actuarial report and requires that the report follow what is considered sound actuarial practice; this section follows the wording in the Canadian Institute of Actuaries Guide to Professional Conduct. We, in

effect, require a going-concern valuation form of report. Even among the four actuaries connected with regulatory authorities, there is no unanimity as to what is really meant by "fully funded," because we are evolving. I believe that perhaps some are tending to think that it would be nice to have absolute requirements. I think most of us still feel that the system we have is preferable, particularly in these unusual times when the old concepts of valuing pension plans are under attack.

II. WHAT SHOULD BE INCLUDED IN A GOOD ACTUARIAL REPORT?

George Poznanski and I and the others have been leaning on the Canadian Institute of Actuaries, and they have finally promulgated a Guide to Professional Conduct which picks up the one from the Society. (We nationalists hated to use the Society's Guides to Professional Conduct.) The new Institute Guide concerns the contents of an actuarial report and generally seems appropriate to me.

Some actuaries are much better report writers than other actuaries. Fom experience I have found that the areas that might be covered more fully in reports are in connection with tests to determine the adequacy and sufficiency of the data. Another matter that can cause a lot of confusion is the greatly increased interest by unions in early retirement provisions with no actuarial reduction and with a bridge benefit payable prior to the employee's becoming eligible for government benefits. It is quite a tricky problem to estimate the effect of that very delicate figure. How do you determine who is going to retire early on full pension?

III. THE ACTUARY'S RESPONSIBILITIES

In my view, there is a close circle of interdependence between the actuary and the profession. The actuary has a responsibility to the profession to uphold its standards, but the profession, I think, has an obligation to develop standards for the practicing actuary. I am very impressed with Bill Dreher's remarks on this point. I know he has been working hard on it for some time. Other actuaries and I have been haunting the Canadian Institute of Actuaries on the same point because neither I, for example (who happen to be a part-time regulator for the Province of Ontario), nor, I am sure, my fellow actuary on the Pension Commission, Laurence Coward, feels at all confident telling the Canadian actuarial profession just what shall be "so and so." However, we certainly notice that there are wide variations in opinions among actuaries as to what are suitable standards and methods, and, going back to our regulations as to what is considered acceptable practice, we try to weed

out those that seem to be up at the far end. We have for some time made use of the Canadian Institute of Actuaries as a tactful way of shirking our responsibilities. That, ultimately, we really cannot do, since it comes back to us. We try, however, to obtain an outside professional opinion from the Canadian Institute of Actuaries on borderline reports. For example, we received a report in which the assumptions were, in the modern jargon, "realistic"—a very high interest rate and a very high salary scale—but the assets at book value were earning 4½ per cent; that report was rejected by the commission.

We are detecting a decrease in the prevalence of the philosophy that the initials which we acquire after passing one set of examinations mean that an actuary knows what he is doing. An opinion was expressed at one of the Canadian Institute of Actuaries meetings a couple of years ago: an actuary was quite cross with the regulatory authorities because someone dared to question his signature on a report—was this not the reason why the Canadian Institute of Actuaries was incorporated? Now this attitude is fading. I think the people in the profession generally realize that the regulatory authorities are trying to help, not to prescribe, and the regulatory authorities realize the problems that actuaries in the field have, particularly in coping with final earnings plans, a falling stock market, 10–15 per cent across-the-board wage increases, and our rules about an experience deficiency!

The actuary has a responsibility to his employer; there are very few one-man shops and not that many fully professional partnerships. Certainly there is a possibility of a conflict of responsibilities, and frankly we see this sometimes in the reports. That is one of the reasons why we have been very desirous of having the new certificate, which the Council of the Canadian Institute of Actuaries recently endorsed, in which the actuary has to say, "yes, those are my assumptions, they did not come to me via New York City or London, England" (or wherever the head office of the employer may be located). One of our problems in Canada is that many of our major industries really are subsidiaries of foreign corporations. Many decisions are not made in this country.

Special-purpose valuations are done to enable an actuary to provide information with respect to several aspects, such as long-term funding programs, solvency tests, and minimum costs. Therefore, we realize very fully that there is no one answer to a valuation problem. We see changes made in the valuation basis. We do not like to have a change made at the same time as the request to withdraw surplus, but we see the need for flexibility.

We had discussions recently with three consulting actuaries who

enumerated their various responsibilities. Not one of them mentioned plan members. I notice that this has been brought out before, but this is what we feel we are there for. If a plan of any significant size goes under and it has not been handled correctly, there will be questions in the provincial legislature of Ontario. The regulatory authorities will be blamed if they have not done their job, and their job is to protect the plan beneficiaries. That responsibility comes ahead of the tax question, the employer's ability to pay, or any other consideration.

The biggest problem that we as regulators face is the lack of adequate professional guidelines for the profession as a whole, which makes your life and ours more difficult.

THE POLICY LOAN PROBLEM

1. Why are policy loans receiving more attention today than they were five or ten years ago?
   a) Types of borrowers:
      (i) Financed insurance—minimum deposit.
      (ii) Arbitrage.
      (iii) Normal infrequent usage.
   b) Impact and implications (especially pricing and policyholder equity problems created by current laws and marketing practices)
      (i) On policyowners, on agents, on different companies (large, small, new, established), on participating/nonparticipating business, on the national economy.
      (ii) On company investment income, lapse rates.
      (iii) On product design.
      (iv) On future legislation (IRS).
2. What are the basic objectives of likely courses of action?
3. What are various companies and state regulators doing at the present time?
   a) Marketing practices?
   b) Policy loan interest rate?
   c) Gross premiums?
   d) Dividends?
   e) Special policies or compensation systems?
4. What other courses of action might be pursued?
   a) Increase the policy loan interest rate. NAIC model bill. Current New York appraisal.
   b) Eliminate the tax deductibility of policy loan interest.
   c) Recognize actual amounts borrowed in the dividend calculation.
   d) Develop product that permits and reflects policyowner's choice of investments, including policy loans.
   e) Others.

Dallas Regional Meeting

MR. CHRISTIAN L. STROM: Minimum deposit did not just happen; it evolved through a series of circumstances.

In the late 1940's, when interest rates were low, use was made of a contract such as twenty-payment life, and the insured would borrow money at his bank at a lower rate than the policy loan interest. He would assign the policy to the bank as collateral.

In the 1950's a split-dollar plan evolved which had higher cash values than the normal policy series in many companies. It did not take long

for our agency force to determine that this was a plan that could be used for premium financing. Shortly after this, with the prospect of inflation coming, there was a demand for insuring the cash value of a contract, and the so-called fifth dividend option or option used to purchase term insurance equal to the cash value was the result.

The first deterrent to minimum depositing was New York Regulation 39 in 1959. An attempt was made to limit the attractiveness of minimum deposit by certain requirements. These actually were not a deterrent for very long, since companies soon began to develop New York and non–New York contracts.

The major deterrent came in 1963 when the Internal Revenue Service set forth its rule requiring four out of the first seven premiums to be paid in cash in order to qualify for tax treatment on the loan interest.

The agent has been attracted to this type of business because he is getting commissions on a whole life type of plan; essentially, however, it is a term product.

Minimum deposit is basically a tax-qualified plan, since the interest on the loan is deductible in a tax return provided that the four out of seven requirement is met. The plan is attractive to the sophisticated and the more affluent buyer who is in a higher tax bracket.

From the company position it is difficult to discourage any insured, and more particularly the affluent buyer, from borrowing on his policy. If a company is to handle each case that has been set up by the agent on a minimum deposit plan individually, it becomes very costly to administer; hence, it has generally been necessary to automate the procedure for determining the payments which should be paid by the owner. In our company the regular premium notice showing the amount of loan interest is sent to the insured or owner at the appropriate time. At the same time a form letter showing the details for a minmum deposit plan is sent to the agent. It is then the agent's responsibility to service the case as a minimum deposit or as a case in which the insured would pay the entire premium plus the loan interest.

Generally, this business has been used with a participating policy, since the cash values on a participating contract are higher than on a nonparticipating, and the fifth dividend option adds to its attractiveness. In its original state this business was profitable to a company, but with continued inflation it has become less profitable, particularly on those policies with a 5 per cent loan rate. Some companies have developed dividend scales reflecting a 5 per cent loan interest rate in New York and 6 per cent loan interest elsewhere. One unfortunate result of the current interest rate situation is the sale of minimum deposit insurance

to the more affluent policyholder. The more affluent policyholder becomes the major borrower in our asset portfolio, as opposed to the less affluent, to whom borrowing is not of real value. With our current investment rates, the less affluent, by not borrowing on his policy, is supporting the affluent policyholder not only in minimum deposit but also in the larger policies which are fully loaned for business reasons.

The persistency on the policy sold to the more affluent has been satisfactory. Poorer persistency has developed where the less affluent individual has been sold on this idea. When the interest on the loan begins to climb, there is not enough tax break to be advantageous to him.

What conclusion can we come to after this discussion? From my point of view, minimum deposit is here to stay, as long as loan interest rates are so much less than current investment rates. It is attractive to the agent because of the commission dollar he is able to collect on what is basically a term sale. It is attractive to the higher income policyholder because of the tax credit available.

What are the possible deterrents to minimum deposit?

1. One is to pay a commission only on the cash remitted by the policyholder, excluding interest; this would be unacceptable.
2. Another deterrent would be to increase the commission rate on term insurance to that on whole life.
3. On participating insurance policies, make an adjustment in the dividend payable based on whether or not there is a loan outstanding. In today's investment market there would be a deduction. If the loan interest rate exceeds current yields, an addition would be made.
4. On nonparticipating policies, develop a rider which would make a positive adjustment for policies without a policy loan. Call it a "premium abatement rider."

However, the best solution to our dilemma is to push for a variable loan interest bill to be adopted uniformly in all states. South Dakota has led the way.

MR. JOSEPH A. KRENZ: During times when new-money rates are substantially in excess of policy loan interest rates, a basic objective, of course, is to restore equity between borrowing and nonborrowing policyholders. By diverting new money from higher-yielding investments into lower-yielding policy loans, higher costs result, either in the premiums charged or in the dividends declared. The problem is complicated by the fact that the degree of inequity varies from company to company

—in other words, to the degree to which policyholders recognize and act on differences in money rates and policy loan interest rates. There seems to be a unanimity of opinion, however, that interest rates will remain high throughout this decade. Last week many of our major banks adopted a record $11\frac{1}{2}$ per cent on prime loans. This week a major bank in Chicago raised its prime rate to $11\frac{3}{4}$ per cent. Thus it appears that the policy loan problem is likely to be with us for quite some time.

The timing of the action is also important. Practical solutions require time, and, during the time that solutions are being considered, rates sometimes reverse themselves or decrease in magnitude to such an extent that the circumstances which originally led to their consideration are no longer so pressing.

Excessive borrowing on life insurance policies during times of high interest rates also places strains on the national economy and tends to obstruct national economic policies. A diversion of funds from normal investment channels could result in further depression of market values and have the tendency to drive high interest rates still higher.

From the standpoint of the company, excessive policy loans during times of high interest rates not only tend to produce lower rates of return but also place drains on cash flow and inhibit forward commitment activity. Without an adequate gauge of policy loan activity, investment officers must exercise extreme caution in making commitments for future investments, lest there be insufficient cash available at the time the commitments must be fulfilled. The total effect is thus to decrease further the investment rate of return.

Therefore, another objective would be to permit competitive forces within our economy to dictate, at least to a certain extent, the policy loan interest rates and thereby reduce the effect of financial selection against the company.

A serious influx of policy loans such as we saw in 1969 would place an almost intolerable burden on our industry. With inflation driving up administrative and acquisition costs and increasing buyer resistance, with seemingly ever increasing competition for the consumer dollar from other sources, and with regulatory bodies and consumer groups of one mind in imposing additional restraints on the marketing of insurance products, it seemed that high interest rates would be one way for the insurance industry to weather the storm. If this avenue is blocked by excessive policy loans, then we can all sit back and muse on the question of why it is that depressions always seem to come when the times are so bad.

MR. JEROME M. STEIN: The policy loan problem concerns not only minimum deposit sales, which use only the emerging cash values of the policy being financed; it also broadly includes sales of new insurance, which derive significant portions of the premium from the cash values present in in-force policies. Such cash values may be derived directly by taking loans or surrendering existing insurance, or they may be used indirectly by such techniques as the exercise of the automatic premium loan on an existing policy.

Among the services available to facilitate financed insurance sales are computer illustrations, which are sometimes provided by the insurance company but are readily available from outside services. These illustrations are significant marketing tools for financed insurance sales involving policy loans.

Policies involving scheduled borrowing over a period of years may be served by special units (in the home office, the general agency, or the branch office) which bill the policyholder for the cash outlay required and which arrange for the loans needed for the balance of the premium. The volume of such transactions in some companies has justified the establishment of computer programs providing annual computer billings which include all the data needed to derive the annual premium from the various scheduled sources. Some companies send the annual schedules directly to the policyholder, while others give the schedule to the agent, who is then expected to use it as the basis for amassing the premium.

Many companies, concerned with improper finance sales, put some marketing restrictions on sales which involve policy loans. Three common restrictions are (*a*) an income minimum for the applicant; (*b*) a minimum size of policy which may be financed by policy loans (due to financial underwriting, this may have a similar effect to the income standard); and (*c*) a provision that only certain kinds of policies may be sold on a financed basis.

A large number of states have enacted replacement regulations. While most follow the National Asociation of Insurance Commissioners model bill fairly closely, each state adds its individual touch. Among the defined replacements are sales involving "substantial borrowing" on in-force policies. Substantial borrowing is usually defined as a loan or a series of loans that add up either to at least a stated number of dollars or to a stated percentage of the tabular cash value.

New York is the only state which still has a 5 per cent maximum loan interest rate. South Dakota is the only state which has passed a flexible loan interest rate law in the United States. Flexible rates are also permitted in Canada.

Large administrative costs are incurred by companies that have to administer several premium scales or dividend scales (annual or terminal) on the same policy form because of differing state laws. Unfortunately, any effect on dividends would be expected to be very small for several years. There is also the problem of setting a precedent in such dividend differentials. Other states may require other significant policy differences (e.g., nonforfeiture provisions or benefit restrictions). Unless the cost differences were truly significant, a company could not afford to reflect such differences in its premium or dividend scales.

For mutual companies, premiums and dividends are two aspects of the same problem. On policies designed for use in financed insurance sales, gross premiums are likely to be higher (or dividends lower) than for similar policies not so designed, because of higher administrative expense assumptions, lower investment earnings assumptions, higher early cash values, and the effect on the asset share of early lapses.

For companies operating in New York, high early-cash-value policies can cause Schedule Q problems due to Regulation 39. The pressures of loans could lead to consideration of reducing dividends on some in-force policies below the levels illustrated at the time the policies were issued. Some companies may be considering adjustments in their termination dividend scales to adjust equitably for the effect of policy loan activity. The termination dividend could also be used to adjust earnings on New York policies which still require the 5 per cent loan interest rate. Dividend adjustment for "equity" should not cost more than the difference in earnings for which the adjustment is made.

It is common to have special high-cash-value policies designed for use in financed insurance sales. The use of different expense margins for various policies can lead to "mix" problems if expected sales volumes for various key policies develop much differently than expected.

In order to develop a higher first-year cash value, some companies have spread the first-year commission over the first two policy years. Others have cut the first-year commission drastically and have increased the next five to nine renewal commissions.

The industry has experienced a few dramatic problems on policies in which the sum of the cash value, the commission, and the expense allowance has exceeded the first-year gross premium. It is the actuary's duty to communicate the difference between reserves and demand liabilities and the difference between cash expenses and allocated expenses.

The policy loan problem is a problem because of the inflation in outside loan interest rates. This panel would have had no problem to discuss in 1950.

MR. KRENZ: Increasing the policy loan interest rate is probably the most practical solution to the policy loan problem, but it has at least two major disadvantages. First of all, of course, maximum interest rates in most instances are set by statute and, before change can occur, fifty state insurance departments and fifty state legislatures must be dealt with. It is unlikely that a state legislature would consider seriously a bill which did not have at least the tacit approval of that state's insurance department. Second, such a change would be felt only gradually on policies issued subsequent to the effective date. Thus a considerable passage of time would elapse before the effect of such an change would be felt. In essence, then, changing the policy loan interest rate would be only a partial solution to the problem as far as present equity is concerned.

At its Washington meeting in 1973 the NAIC adopted a model policy loan interest rate bill which permitted a variable interest rate. Its adoption followed at least two years of study and at least two different task forces. Its main characteristics are the following:

1. Policies may provide for either a fixed or a variable loan interest rate. Companies may issue policies with either a fixed or a variable loan interest rate, but both alternatives may not be contained in the same policy. In other words, a policy may contain either but not both.
2. The maximum fixed and variable loan interest rate would be set by each state enacting the bill.
3. Only one change would be permitted in any twelve-month period. This change would apply to all loans made thereafter—until a subsequent loan interest rate change.
4. Any change in the loan interest rate could not exceed 1 per cent per annum above the previous rate.
5. In maximum loan situations, insurers would be permitted to withhold from loan proceeds an amount sufficient to preclude the possibility of lapse due to an increase in the applicable interest rate.

No provision was made in the bill for determining the effective date of a rate change, that is, policy date, loan date, or calendar year. Such a decision was left up to the insurer. Determining the effect of the three alternatives on such things as promoting equity among borrowers, different policies, "rolling" loans over to heavy borrowing, and the like, has many of the characteristics of a Part 5 problem. It was the opinion of the task force that the calendar year was preferable because it is reasonably equitable and responsive to the economy, it treats all policyholders equally, and it is conceptually simple.

The bill provides for a thirty-day advance notice of any specified rate increase on outstanding policy loans.

Although the use of a variable policy loan interest rate will complicate the administration of policy loans, the model bill has the advantage of offering an option to the insurer to elect the traditional fixed rate.

Even though the model bill represents a very viable solution to the policy loan interest problem, it should be kept in mind that the usury laws of each of the various states will set ceilings on the maximum rate permissible.

The American Life Insurance Association has been most active in seeking to introduce the NAIC model bill to state legislatures. Attempts have been made in some twenty to twenty-five states. Not only is a tough educational problem involved, but 1974 is also an election year and the last thing a campaigning politician wants to be bothered with is a bill to increase interest rates.

The bill has been introduced formally in only ten to fifteen of these states and to date has been passed by only one.

South Dakota became the first state to adopt the model policy loan interest rate bill when Senate Bill 43 was signed into law. It became effective on July 1, 1974. Previously, South Dakota had a 6 per cent maximum permissible policy loan interest rate. Under the new law, the maximum fixed or variable interest rate may not exceed $8\frac{1}{2}$ per cent. With the exception of minor modifications to fit South Dakota statutes, the law is exactly the same as the NAIC model bill.

The bill was sponsored by domestic South Dakota companies and had little difficulty in the Senate but ran into unexpected trouble in the House. The mere fact of an increase in interest rates was enough to dampen enthusiasm but, when combined with a variable rate that might go up or down, caused legislators to question the need for such legislation. The tide was turned finally when a veteran legislator took the floor of the House and stated that life insurance was never meant to be "borrowed out." This, combined with the argument that the unsophisticated policyholder, that is, the nonborrower, was subsidizing the more sophisticated policyholder, that is, the borrower, did the trick and the bill finally passed easily.

The same happy situation has not evolved in New York, however. Earlier this year a proposed act was drawn up for presentation to the New York legislature. It had some of the characteristics of the NAIC model bill. In essence it provided for a variable loan interest rate, to be established by the insurer, not to exceed the lesser of the maximum rate for new loans permitted by the banking law or a rate 1 per cent higher than the rate of interest being paid by the insurer on proceeds under settlement options not involving life contingencies. It is my understand-

ing that the bill was never introduced and is now apparently a dead issue, at least in the state of New York. It is interesting to note that tying the variable interest rate to the company's settlement options was a suggestion expressed by some of the membership of the NAIC at the time the model bill was being considered.

Another solution would be to eliminate the tax deductibility of policy loan interest. The IRC currently allows, subject to some limitations, a deduction from a policyholder's gross income tax for policy loan interest actually paid. Aside from pragmatic questions of whether or not such a change could possibly be effected, doubt exists also as to whether or not elimination of tax deductibility for policy loan interest would constitute a serious deterrent to the usual type of cash-value loan. There are other persuasive reasons that argue against such a course of action. It would have a tremendous impact on, and virtually dry up, new sales of minimum deposit insurance. It is inconsistent with tax theory. From the standpoint of the individual policyholder, who is not on a systematic program of borrowing, it would seem patently unfair to permit him a tax deduction on his home mortgage or bank loan and not on his policy loan, particularly since he considers this his own money. It would have the over-all effect of decreasing the attractiveness of the life insurance product. Finally, it would affect all policyholders, even those owning insurance in companies not experiencing excessive policy loans.

From time to time, it has been suggested that the actual amounts borrowed be considered in the dividend calculation. Certainly a good theoretical argument could be made in favor of this practice, and our chairman, Jim Reiskytl, could probably hold forth for the rest of the day on it. Yet the antidiscrimination and unfair trade practices statutes are broadly written and have been interpreted liberally by state regulators. Additionally, a great deal of mystery surrounds company dividend formulas, and a strong suspicion exists that they involve as much art as science. It follows, therefore, that most state regulators would probably view such a procedure with something a good deal less than enthusiasm. Dividend differentials would create serious problems of an administrative, actuarial, and sales promotion nature. Finally, such a solution would not offer relief from substantial borrowing among policyholders of stock companies.

An alternative would be to develop products that permit and reflect policyowner's choice of investments, including policy loans. In this respect, variable life insurance would be the classic example. However, new products, particularly those involving radical new concepts, generally find slow acceptance with regulatory bodies. Not infrequently the

product itself must be modified in some important respect to secure such acceptance. Where one deals with the investment performance of the company, one runs afoul of not only the NAIC but also the Securities and Exchange Commission, not to mention the IRS. While undoubtedly a great deal of ingenuity could be brought to bear in the development of such new products, the project would involve a considerable amount of expense and a large expenditure of time as well. All this is with no assurance that the final product would be acceptable either to regulatory bodies or to the buying public.

Everything considered, adoption by the states of the NAIC model policy loan interest rate bill would seem to present the most practical answer to problems created by excessive policy loans. Although admittedly only a partial solution to the complex problems involved, it would result in a policy loan interest rate that would be considerably more responsive to general market rates; it would introduce a degree of competition into the setting of policy loan interest rates; and it would permit each company to select an option suited to its own individual corporate needs.

CHAIRMAN JAMES F. REISKYTL: Equity between the borrower and the nonborrower with participating insurance can be achieved currently either by recognizing the actual amounts borrowed in the dividend calculation or by urging everyone to borrow. Today's borrower reduces investment income for all policyholders, since the guaranteed interest rate on his policy loan is substantially less than the investment rate on other new investments. If his dividend does not reflect the lower contribution to surplus made by borrowed values than by nonborrowed values, he can reduce the cost of his insurance voluntarily (by borrowing and reinvesting at the current market rates) and increase the cost of insurance for the nonborrower. Since everyone desires insurance at the lowest cost, there is little the nonborrower can do except to become a borrower. For obvious reasons, we do not wish to achieve equity by urging everyone to borrow.

There are a number of possible ways to recognize the actual amounts borrowed in the dividend calculation so as to distribute surplus more equitably. One way is to create a new dividend class for all policies with the same policy loan interest rate—for example, one class for all policies with a 5 per cent policy loan rate and another class for all policies with a 6 per cent rate. Classes are defined at issue, and everyone is treated alike, since all have the right to borrow. Dividends reflect the investment earnings on the borrowed and nonborrowed values of each

class. A number of companies have already taken this step, which provides a more equitable distribution than one that considers everyone to be in the same class. Nevertheless, this traditional dividend class method does not relieve the inequity between the borrower and the nonborrower.

Another way to preserve equity is to create a separate dividend class for all policies with a loan at a specified loan interest rate, regardless of the size of the loan. For example, all policies with an existing 5 per cent loan might be in one class, all with a 6 per cent loan in another, and the nonborrower in a third. Dividends for each class would reflect the earnings on the amounts borrowed and not borrowed, as before. This method is more refined than the first one, but the improvement may cause legal problems.

One also could credit the interest gain of the dividend for each policy in two parts—one rate, reflecting the earnings on policy loans, would be applied to the average amount of cash value borrowed during the year, and another rate, reflecting earnings on non–policy loan investments, would be applied to the nonborrowed value. This method attacks the problem directly and achieves greater equity.

Another way could be to adopt a type of investment-year method for determining the interest gain portion of the dividend which would reflect current and prior investment rates, including portions invested in policy loans.

The policy contract could be redrafted to sever the policy loan from the remaining policy reserve for dividend purposes. The policy loan interest rate would be ½–1 per cent above the assumed interest rate to cover expenses and taxes. As a result, the portion borrowed makes no contribution to surplus, and the dividend reflects only excess earnings on the remaining value, if any. Mr. Norman Peacor described this method about two years ago in a *Journal of Chartered Life Underwriters* article.

MR. STEIN: Since the one-year term rider is an essential part of a financed sale of a participating policy, a possible technique to provide equitable treatment of such sales would be negative dividends on one-year term riders. In practice, the amounts of adjustment would probably be too small to be of much value.

CHAIRMAN REISKYTL: Requests for other refinements in the dividend calculation could be a problem. If the factor were significant, it should be recognized. Each request would have to be considered on its

own merits, the costs of doing it being weighed against the effect of the improvement in equity.

MR. RICHARD L. GIBBS: Mr. Reiskytl has suggested that, aside from legislation which would permit higher interest rates to be charged on policy loans, one possible solution to the policy loan problem would be to decrease dividends on policies with loans outstanding by reflecting actual amounts borrowed in the dividend scale. While this procedure would be a good practical solution, I am afraid it would be challenged from a legal standpoint. The proposal would in effect create a separate dividend class for those policies in which the policy loan provision was elected. However, many state statutes on the distribution of surplus are interpreted in such a way as to limit separate dividend classes to significant characteristics only *at issue* of the policy. The exercise of a policy loan provision is a condition subsequent to issue. Since its eventual election cannot possibly be known at issue, separate dividend class treatment for these policies may be construed as violating the statutory requirements.

CHAIRMAN REISKYTL: Although the principal court cases that have discussed guidelines for dividend classes, such as *Rhine* v. *New York Life Ins. Co.,* have held that conditions at issue establish a class, I am not sure that these cases necessarily limit the definition of a class to the conditions at time of issue. To my knowledge, the question whether one can differentiate between the borrower and the nonborrower in the dividend factors has never been tested, so there is no direct legal precedent. It has been established that the directors have a great deal of discretion in determining an equitable apportionment of surplus among the policyowners.

Dividend classes are determined by the characteristics of the policy, not by characteristics of the individual insured, except those which were used to determine the policy in the first place. It is possible that dividend classes could be defined to include policy characteristics at issue, as has been the traditional practice, as well as subsequent to issue, which would permit the direct recognition of individual policy loan activity. This would continue to prohibit subsequent recognition of changes in the insured's physical condition.

MR. RICHARD S. MILLER: I would like to question again why direct recognition of the loan in dividends is not "permissible." We have a situation in our pension trust area which seems analogous. Our level premium pension trust policies are nonparticipating but do contain a provision whereby we can pay excess interest. We have been paying excess

interest on these plans according to an investment generation method for some time. While policy loans are very rare on this business, if a policy does have a loan the excess interest otherwise payable is reduced by a loss-of-earnings factor times the loan outstanding. This process currently eliminates excess interest payments for 5 per cent loan provision policies which are more than 60 per cent loaned. We have had only one protest of this treatment, and the applicable insurance department agreed with us that, since we were not earning any excess investment return, we had no obligation to pay the affected policyholder.

MR. DALE R. GUSTAFSON: The NAIC model variable policy loan interest rate legislative picture really is not as black as Joe Krenz suggested earlier. Although South Dakota is the only state that has passed the bill, that taken by itself is misleading. The ALIA efforts to get the bill introduced were begun quite late in the state legislative sessions, which considerably reduced its chances of passing. We fully expect that with timely introduction and active support many states will pass the bill in the next few years. Over half the states do not require enabling legislation.

MR. STEIN: For the typical purchaser of life insurance for family protection purposes, the cash value is a key feature of his policy. It often becomes a major part of his total savings and is available for the true emergencies of life. Such policyholders have no intention of borrowing routinely to pay premiums. The variable interest bills will neither protect them nor significantly offset their borrowing. They can be protected from improper and disadvantageous financing only by internal company marketing and administrative controls.

MR. STROM: Policy loan values have played an essential role in the past. According to the *Life Insurance Fact Book*, policy loans totaled 15 per cent of company assets in 1930, when this was the only source of money for many people. The percentage as related to assets began decreasing in 1935 to a low of 3.6 per cent in 1955 and then gradually increased to 7.9 per cent in 1973.

CHAIRMAN REISKYTL: The problem we face today has many aspects that did not exist in the 1930's. Minimum deposit plans, introduced in the fifties, have become increasingly popular, and arbitrage opportunities at significant differentials above the policy loan rate are currently available to everyone. Record-level market investment rates have also added many borrowers to those who must rely on policy values as their only available source of money.

The ratio of policy loans to ordinary life insurance reserves shows the same trend as the ratio of loans to assets and is more representative of the size of the problem. At the end of 1972 this ratio was a little over 16 per cent. Currently this ratio varies considerably among companies—at least one has over 40 per cent of its policy values loaned out.

MR. MILLER: Turning to the minimum deposit questions, our experience seems atypical. Since 1963 we have marketed policies which were ideal for minimum deposit use and on which we will automatically administer a minimum deposit payment scheme. These policies pay a first-year commission of 30 per cent, with fourteen renewals at 10 per cent. These commissions compare with the normal schedule of 65 per cent the first year, two renewals at 10 per cent, and seven at 5 per cent. Compared with other issues which would have met the minimum $25,000 issue rules for these policies, our minimum deposit policies have shown significantly better lapse experience than similar-sized regular policies, the actual-to-expected lapse ratios being 22 per cent better. Mortality rates have been 40 per cent higher, but with only twenty-eight deaths the significance is suspect. The explanation may well be that these forms also work quite well in split-dollar and business situations, and the very substantial renewals have been attractive to our best agents.

CHAIRMAN REISKYTL: Four years ago, the Northwestern Mutual Life conducted a very successful loan repayment campaign. We contacted over 340,000 policyowners with existing loans, suggesting that they consider repayment on a regular basis, and almost $6 million was repaid during that year. We are currently ready to launch another repayment program as soon as the prime rate comes down from its present lofty levels.

MR. THOMAS K. PENNINGTON: In order to stimulate loan repayment, Protective several years ago adopted a program of soliciting loan repayment from policyholders by preauthorized check. This program has been moderately successful, and currently we have 176 policyowners who have authorized monthly drafts to reduce their outstanding loans. These drafts range between $10 per month and $500 per month, and currently we have approximately $9,000 per month loan repayments.

As a related program, we have eleven home office employees repaying policy loans on a salary savings deduction basis with another $400 to $500 per month of loan reduction. While these amounts are not material in relation to the average $200,000 a month of new loans we experience,

they do reduce our cash-flow problems slightly and at the same time reduce these policy loans and improve the policies.

We feel that the program has been worth the solicitation cost of these preauthorized checks.

CHAIRMAN REISKYTL: Double-digit inflation or anything close to it is a severe problem that affects life insurance in many ways. As the dollar shrinks in value, benefits—both death protection and cash values—which were once considered adequate become less and less so, especially for the nonparticipating purchaser. Participating insurance benefits feel the same pinch, but to a lesser extent, since increased dividends applied to purchase additional insurance have been able to keep pace with inflation fairly well. Premiums are also being paid with "smaller" dollars.

Inflation drives up the investment rates, which in turn increase the dividends on participating insurance and reduce nonparticipating premium rates for new issues. Unfortunately, higher interest rates also mean escalating federal income taxes as the progressive rates take larger bites out of incremental income, particularly for Phase 1 companies. In a few years the marginal tax rate on incremental dollars will exceed the full corporate rate for some companies as the "10 for 1" required interest deduction peaks. This escalation of taxes makes it increasingly difficult for participating dividends to continue to offset the inflationary pressures. Permanent coverage will become less attractive as long as other financial institutions are not subject to similar tax burdens.

Coupling this situation with the emerging policy loan problem, we have a real threat to the basic life insurance product—at least the one we know today. Record high market investment rates and artificially low guaranteed policy loan rates make borrowing of policy values extraordinarily attractive today for both cash needs and arbitrage. Increasingly, policy loans will become the first, rather than the last, resort. For many companies the growth in policy loans is already reducing future dividend-paying capability on participating business or reducing the profit on nonparticipating business. For others the impact has been relatively small to date, but the potential is there for all if present conditions continue. Pricing inconsistencies also develop as heavily borrowed permanent coverage becomes cheaper than term insurance for many buyers.

Some way must be found to separate the borrower and the nonborrower so that we can continue to attract the nonborrower to our permanent products. If not, the effects will be widespread. It will become increas-

ingly difficult to compete with other financial institutions for savings dollars. The economy will have to find another supplier of capital for those normally served by the life insurance industry, and the cost of our product will go up. We will be faced with poorer persistency and the probable need to restructure the compensation and marketing of our product.

Faced with inflation that may continue at something close to the present level for the rest of this decade, we may have to take another look at our individual life products and traditional pricing practices. For example, the portfolio-based dividend interest rate has served well, but it may have to be replaced with an investment-year approach which would recognize the timing of investments and could possibly distinguish between policy loans and other investments.

New individual products may have to be developed which credit current investment rates (and hopefully also provide some relief from the increasing federal income tax bite), as has been done in the group and settlement option areas. Life-cycle or variable life policies with a choice of investment accounts—such as bonds, mortgages or real estate (REIT), common stock, short-term paper, and policy loans—may be an answer.

MR. PATRICK L. WILLIAMS: Could you please comment on the mechanics of recognizing policy loans in the dividend formula? For a person who has his cash value loaned out for only part of a year, do you use an averaging technique?

CHAIRMAN REISKYTL: Quite likely. One way to do this would be to set aside a new weighted average loan balance field on the master record for each policy. This balance would be calculated as the amount of the loan times the period remaining to the next policy anniversary. For example, a new loan of $100 taken out in the middle of the policy year would be considered to be a $50 loan for the entire year. Each policy year the field would be cleared and any existing loans would be entered. During the year, any new borrowing times the period remaining to the next anniversary would be added to the account balance and any loan repayments times the period remaining would be deducted, so that at the end of the year, the total would equal the average amount borrowed during the year. The interest portion of the dividend would then reflect the appropriate earned rates on the amounts borrowed and not borrowed.

MR. STEIN: Charging the over-all portfolio new-money rate of return on policy loans might not be fair, since most other types of investments involve higher levels of administrative expenses.

CHAIRMAN REISKYTL: We have been through three credit crunches since 1965, and many experts contend that this pattern is likely to continue. Each time policy loan activity spurted and then receded, but unfortunately the new level always ended up higher than it was after the last crunch. Something must be done, but it is very difficult to find a solution that will work for both new and existing business and for participating and nonparticipating business. There probably is no answer. For new business the ideal may be to eliminate the provision, but this is impractical and in many cases illegal. The best course to pursue at this time, at least in the opinion of some, is a higher variable loan rate. The Canadian companies have already taken this step, since all rate restrictions on new business were removed in 1968. Companies currently are charging 7–8 per cent. They have the same problem the United States companies do with prior existing business.

For existing business, views vary as to the best practical course to follow. Many contend that the probable legal problems of reflecting actual borrowing in the dividend scale will keep companies from taking this route, and quite likely there is nothing that can be done. Others disagree, hoping that continued study will find a workable solution to this growing problem.

Montreal Regional Meeting

CHAIRMAN ROBERT T. JACKSON: At the time I was asked to chair this discussion, the policy loan problem was not nearly as important as it has become since that time. It seems quite evident there is no chance that interest rates are going to be a great deal lower in the foreseeable future, and it appears that we are going to have a serious problem for a good while. The problems for a mutual company seem particularly acute, because they are problems of equity between policyholder classes.

A couple of days ago the president of the First National City Bank indicated that by the end of 1974 prime interest rates would drop to 7 or 8 per cent. Even if he is right, this will not mean any relief for us on policy loans.

MR. ARTHUR C. CRAGOE: With the average industry interest rate equal to the maximum loan interest rate of 6 per cent and new-money rates anticipated as 8 or 9 per cent for years to come, there are many

obvious aspects to the policy loan problem that were absent ten years ago.

Until August 7, 1963, there were few legal hindrances to financed insurance. In the mid-1950's some companies that specialized in sales to businessmen and other sophisticated buyers of large policies created special policies to attract minimum deposit business. While New York's Regulation 39 prohibiting first-year loans slowed the concept of minimum deposit, the feeling is that the death knell was sounded by the Treasury's ruling that policies purchased August 7, 1963, and later had to pay four years' premiums out of the first seven in cash in order to have interest paid in cash considered a deductible federal income tax item to the policyholder.

When guaranteed investments are being offered at rates sufficiently above policy loan rates, arbitrage in the form of making a policy loan and immediately reinvesting at a higher interest rate is bound to happen. It is really a question of how much interest differential it will take. My guess is that it would take a 3 per cent or higher interest differential on a long-term secure investment to create a sizable amount of arbitrage. Such a differential is fast becoming a reality.

When credit costs become sufficiently higher than our loan interest costs, and appear to give promise of staying higher for several years, we are bound to see more bankers, newspaper columnists, and others advising people to borrow their policy loan equity first, before using other credit institutions. This could be a serious problem to every company, not just to the minimum deposit specialists, and is counter to our traditional view of considering policy loans as a last resort. At Franklin Life the reasons we now hear most often for making a policy loan are to buy a new car and to make a down payment on a new house. There was a sharp upturn in our new loans in late 1973 (moderated, fortunately, in early 1974). The peak in late 1973 among all companies exceeded the giant waves of 1966 and 1969 and far exceeded that of the year 1972.

From a chart on rises in the cost-of-living index, it seems that when policy loans take a big jump, inflation is also swinging upward, since the cost-of-living index takes a good rise shortly thereafter. The loan volume may recede from peak to peak but in recent years has not returned to original levels after each wave.

In 1969 the MAP study (Monitoring Attitudes of the Public), done under the guidance of the Institute of Life Insurance, indicated that 15 per cent of the people surveyed believed one should never borrow on a life insurance contract, 64 per cent said one should borrow only as a last resort, and 17 per cent said it was one of the best sources for

loans. Evidently the public, in the past, has shared our views that policy loans should be a last resort. However, more are now using policy loans as a first resort.

If we do not raise the interest rates on policy loans, the general public undoubtedly will become educated more and more to believe that policy loans are one of the best and cheapest sources for new loans of all kinds. This cannot help weakening the protection function of our policies as well as impairing the investment performance of the industry.

For discussion purposes, I put forward the thesis that when bank loan interest rates on top quality collateral and personal notes exceed policy loan rates by 2 per cent steadily over a ten-year period, the general public, by the end of that period, will have become accustomed to exhausting policy equity before doing any other type of borrowing. Once this trend becomes an established habit among a generation of policyholders, agents and others will stimulate and perpetuate the practice among new policyholders by promoting the idea when a policy is sold. Thus the entire character of our product could undergo a serious change within ten years.

Excellent papers on policy loans have appeared in the *Journal of Risk and Insurance*. In December, 1970, Wood and Rottman presented the case for variable loan rates, and in December, 1973, Greene warned of the dangers of a variable rate. In the Wood and Rottman article it was pointed out that, in the period from 1930, new investment yields have exceeded policy loan rates only since about 1958. The differential was not great until the late 1960's. Thus we may not be able to use the past to predict the future when it comes to the impact of loans on the total company financial picture. A second chart, however, provided a very interesting profile of the increases and decreases in loan volume, and the increases and decreases in the bank prime interest rates. It is obvious that conditions that produce increasing prime rates also produce increasing volumes of new loans.

The current impact varies extensively among companies. The November, 1973, issue of *Best's Review* shows ratios of loans to assets as of year end 1972 varying among companies from 2 to 27 per cent. Some large stock companies are as low as 2–3 per cent. The giant mutuals now seem to be in the 4–6 per cent range. Then there is a group of average companies, participating and nonparticipating, in the 10 per cent area. Next comes a group of larger mutuals specializing in business insurance. They have 14–17 per cent of their assets in loans. Finally, the companies known for minimum deposit business have percentages from 20 to 27 per cent.

The small participating companies (because of expense limitation) and the nonparticipating companies (because of lack of dividends) cannot ameliorate their loan positions as easily as the large participating companies that might create separate dividend classes, and the chart shows only a few such companies that have a serious problem today. It does appear, however, that the stage is set for a potential problem for all companies in the future.

Perhaps we can agree that we have entered an era of new-money investment rates of well over 6 per cent, and that the era will probably last ten to twenty years. Then, from my point of view, the following are implications of continuing the present 5–6 per cent legal maximum loan rates and continuing marketing practices that emphasize loans:

1. The policyholder will be educated to use his policy loan values as a first source for money wants.
2. Because there is no enforced repayment, a good number of loans will tend to remain unrepaid.
3. Agents will have a seemingly good case for replacements of existing insurance to eliminate indebtedness without a sizable increase in premiums. This "churning" of the insurance account makes the company look good on new sales, the agent happy to get a new commission, and the policyholder relatively happy, since he has been resold on starting a new plan and rather painlessly repaying his loan.
4. Some large participating companies with high percentages of loans may try to create separate dividend classes for borrowers and nonborrowers. If this is considered inequitable, they may try to create separate dividend classes for policyholders with 5 per cent maximum loan rates as in New York, for 6 per cent states, and for variable interest rate states.
5. If a new company has used financed insurance as a means of growth, it will have a large percentage of assets in loans, which will depress its interest earnings rate. If it were a stock company, this might hurt its stock prices, since it would look less well managed than a similar new company without a large policy loan account. This could be misleading, since the financed insurance can be considered essentially term insurance with increasing premiums (and ordinary life commissions). From a cash-flow point of view, one could eliminate the loan activity in analyzing the assets of such a company.
6. A good question for economists is: What is the implication of a continued high level of loans from the point of view of the national economy? On the one hand, our industry could be considered akin to a bank that would make 5 or 6 per cent loans despite rates charged by other institutions. This could be considered in the national interest by those who favor mandatory low interest rates. On the other hand, it could be argued that granting such loans keeps the brake off spending at the very time the forces

of supply and demand are trying to hold down inflation by high interest rates. Also, increases in policy loans cut into the cash flow that would otherwise be available for long-term investment, diverting capital expenditures into current consumption. It seems just as artificial to have a large volume of low-rate policy loans build up as assets on our books as it was to have the large volume of low-rate government bonds forced on the companies during World War II.

7. When World War II ended, the companies eliminated their low-yielding government bonds as soon as possible. Similarly, if a sizable block of low, fixed-interest loans is built up and a change is made to allow higher rates on new insurance policies, companies may not resist too severely the replacement of loaned policies to eliminate this low-yielding asset.
8. Some possible product implications of having 20–25 per cent of our assets in loans are the following: an upper ceiling on assumed interest rates for new products; the possibility of an upward trend in lapse rates, say around the tenth to the twentieth year; emphasis on lower-premium and lower-cash-value plans; and a ceiling on premium prepayment interest rates. Another possibility is to develop markets where the invasion of cash values is restricted in some way. For example, H.R. 10 plans and tax-sheltered annuity plans exact severe tax penalties for loans. Hopefully, our industry will encourage a United States counterpart to the splendid Canadian Registered Retirement Savings Plan program, where any life plan can obtain a tax deferment on an arbitrarily calculated savings portion of the premium. To be registered, one must give up the loan privilege but can retain the reduced paid-up nonforfeiture privilege.

MR. HAROLD G. INGRAHAM: What are the basic objectives of likely courses of action? There are several that come readily to mind: (1) to find some means of inhibiting extreme drains on the cash flow of insurers during periods of high market interest rates; (2) to modify marketing practices; (3) to improve policy persistency; (4) from a pricing standpoint, to provide more equitable treatment as between borrowing and nonborrowing policyholders; and (5) to encourage policy loan repayments.

CASH FLOW

Studies have shown that interest rate variations are, by far, the most important single influence affecting policy loans and have the most immediate impact. This is particularly true of short-term interest rates. Prior to the 1973 upsurge in policy loans, a 4.5 per cent interest rate on commercial paper appeared to have been the threshold level. The threshold in 1973 apparently moved to 5.5 per cent, the real impact being felt as rates moved to over 8 per cent.

The sharp upsurge in policy loans occurred over a considerably shorter period in 1973 than in 1966 or 1969–70. This was probably attributable to the Federal Reserve's February, 1970, action limiting minimum Treasury Bill purchases to $10,000. For most companies it was only in August, 1973, after banks began to offer 7.5–7.9 per cent $1,000 four-year savings certificates that very large policy loan outflows occurred.

Of course, policy loans are not yet back to their average 1971–72 level, and it is questionable whether they will soon return to that level, in view of the prevailing level of inflation and high short-term interest rates. These factors serve to preclude the likelihood of significant increases in loan repayments and continue to make policy loans a relatively attractive source of borrowed funds.

A recent study of investable cash flow attributable to the ordinary line at New England Life (NEL) during the period 1955–73, inclusive, discloses the following information:

1. Ordinary cash flow in recent years has averaged considerably less than during the late 1950's, although the company's total invested assets over the last nineteen years increased from $1.5 billion to $4.0 billion.
2. About 55 per cent of NEL's 1973 increase in admitted assets resulted from policy loan increases.

The need to monitor and forecast insurance company cash flow is self-evident. During periods of high interest rates, the lost investment income caused by policy loan increases in lieu of market investments in mortgages and securities may ultimately have an impact on the company's dividend scales and competitive position, its ability to expand into new markets or to provide additional services, and its rate of agency growth and degree of market penetration.

MODIFICATION OF MARKET PRACTICES

For a number of companies, the systematic programming of policy loans to achieve minimum premium outlays on nonpension business has increased pervasively over the past several years. At NEL noncash policy loans have steadily marched upward from $30 million in 1968, to $41 million in 1970, to $50 million in 1973 and $19 million for the first four months of 1974. There are several reasons why this has happened:

1. Much higher first-year commissions on minimum deposit whole life than on term policies or term rider/whole life packages.
2. Agents face rising personal and business expenses, and therefore require increasing incomes achievable only through larger sales volume on essentially a static number of lives sold per year.

3. Policy loan interest remains deductible pursuant to section 264 of the Internal Revenue Code, subject of course to the "four of first seven" premium payment rule and other limitations. Moreover, many policyholders apparently cavalierly maximum-loan their policies in *every* year and deduct the loan interest—adopting a "catch me if you can" attitude with the IRS.
4. The emergence and profusion of organizations providing computer-prepared financed insurance illustrations, often using in-agency terminals. From a marketing standpoint, these services relieve agencies of laborious calculations, provide illustrations quickly, and create "status" with clients. From a company's standpoint, such services may be a source of grave concern, since (*a*) they often advise as to detailed procedures for systematically stripping in-force policies to finance premiums on new policies and (*b*) they are often inaccurate, not meeting minimum standards of company-prepared illustrations.
5. Another facility fostering minimum deposit selling practices is the automatic premium loan policy provision, permitting automatic payment of the premium balance after loan interest and any part of the premium is paid.
6. The so-called fifth dividend option was introduced in the late 1950's by mutual life insurance companies for particular use in split-dollar sales. However, it appears to have become an integral aspect of minimum deposit programming using high early-cash-value (HECV) policies. The 1971 Life Insurance Association of America Joint Policy Loan Study Committee report indicated that among HECV policies studied where the fifth dividend option was elected, total policy loans outstanding were 77 per cent of available loan values.

IMPROVEMENT IN POLICY PERSISTENCY

Studies at NEL of comparative lapse rates on nonpension policies with loans as opposed to similar policies without loans indicate a bleak long-term persistency profile for policies with loans. One study analyzed HECV policies for over $50,000 face amounts where at least 50 per cent of the available loan value was loaned out at the beginning of the observation period. The study showed lapse rates as predictably minuscule in the first policy year, then averaging at about 8.5 per cent per year for policy years 2–7, and dropping suddenly to 4.0 per cent in policy years 8–10.

This study also showed that only about 45–50 per cent of minimum deposit sales at NEL can be expected to persist for ten years. However, our studies of nonpension business not subject to any borrowing indicate a ten-year persistency expectation of about 75 per cent, for all premium modes and face amounts combined.

Additional studies at NEL have disclosed even more chilling results:

1. Policies with loans are two and a half to three times as likely to terminate as policies without loans, for policy durations 2–7.
2. A study of relative persistency by policy-size group showed that, for policies of $100,000 or over in face amounts, policies with loans had a ten-year persistency expectation of 36 per cent, compared with a comparable 79 per cent figure for policies without loans.

These studies are representative of only one company's experience. To me they seem to indicate a persistency pattern closely comparable to pension trust experience rather than the traditional Linton or Moorhead tabular assumptions.

EQUITY BETWEEN BORROWERS AND NONBORROWERS

Policy loans at 5 or 6 per cent interest today represent assets that otherwise could be invested in fixed-income securities or mortgages at substantially higher yields. Such yields would enhance a company's investment portfolio interest return and hence the excess interest element of its dividend scales. In effect, dividend scales for all policyholders are currently constrained, and the resultant net cost of insurance increased, by reason of low policy loan interest rates. Yet the benefit of these low rates accrues only to those policyholders who carry policy loans. Stated another way, policyholders who borrow are being subsidized by policyholders who do not.

In the *Rhine* and similar cases the courts held that disability income riders were integral parts of policies and upheld the rights of companies to treat such policies as a separate class for dividend purposes. These cases appear to permit the establishment of separate dividend classes, in situations where individuals possess the *contractual privileges* of electing settlement options at different purchase rates or making policy loans at different policy loan interest rates. However, no case law has yet addressed itself to the legality of distinguishing in dividend classes between, say, policy borrowers and nonborrowers. It is possible that such dividend classifications would be held in violation of laws against discrimination and even viewed as a scheme to circumvent the maximum interest rate laws for policy loans.

However, it is possible to argue with considerable vigor the propriety of such a distinction. Consider the following line of reasoning:

1. For cash-value life insurance, we know that a part of the guaranteed loan value increase each year stems from interest earned on funds held by a company. Also, excess interest over the statutory reserve interest rate

applied to the initial reserve constitutes an important part of dividends payable.

2. To the extent that the existence of a policy loan is recognized as representing funds that a company does not have available for investment, is it not equitable for *reduced* excess interest credits to be accorded these funds in the interest elements of the dividend formula?
3. Such an adjustment, achieved through defining a separate dividend class for policies with outstanding loans, properly would reflect the fact that these policies make a reduced contribution to divisible surplus.

POLICY LOAN REPAYMENTS

A 1971 LIAA special study of policy loan repayment programs disclosed that about 70 per cent of company respondents to a questionnaire indicated that they had such programs in operation. The simplest and least costly approach has been to use a card, simply suggesting partial or full repayment, enclosed with the premium notice reminder to all policyholders with outstanding loans. Some companies go a step further by providing the borrowing policyholder the option of indicating on the card his desire to set up a regular repayment schedule. For policyholders exercising this option, these companies issue standardized repayment forms or booklets of forms for use with each repayment.

With respect to the possibility of compensating agents for policy loan repayments, virtually all companies would be reluctant to use this approach. This is because agents might encourage policy loans with select policyholders who would pay off the policy loan and shortly thereafter reborrow, thus permitting the agents to receive commissions not only for selling the original policy but for policy loan repayments as well, with no appreciable reductions in the company's total dollar volume of policy loans outstanding.

What are various companies and state regulators doing at the present time?

MARKETING PRACTICES

Many companies have analyzed their nonpension permanent business by recent calendar year of issue, and by agency and agent, to determine proportions of business with outstanding loans. Agencies with high ratios can be monitored and guidelines can be established by the company's chief marketing officer and his line directors regarding the levels of cash values borrowed which are deemed reasonable for a given agency in a particular marketing region. Obviously, entrenched agency selling patterns are not easily changed in many instances. And it takes considerable courage for marketing officers to terminate agency heads or

agents who have produced substantial past volumes of business, albeit minimum deposit business.

Some companies have begun conditioning agents' qualifications for leaders club meetings and have established agency trophies or awards on policy loan ratios. At least one company has developed an incentive expense allowance plan for general agents, under which base allowances for each agency are developed reflecting premium growth and are then redistributed on the basis of agency persistency and policy loan ratios related to company average experience in each category.

POLICY LOAN INTEREST RATE

For policies issued since 1969, a great number of companies have moved to a 6 per cent policy loan interest rate, except in New York, where 5 per cent is the maximum rate permitted. At the present time, 6 per cent is a statutory ceiling imposed by twenty-three states. The remaining states impose no maximum except by application of the general usury laws.

At its June, 1973, meeting, the NAIC adopted a model bill to permit variable interest rates on policy loans. This model bill, of course, has no effect until it is enacted on a state-by-state basis, and it will apply only to policies issued in a particular state after that state has enacted the bill. The bill provides that a policy shall contain a provision establishing either, but not both of, a variable policy loan interest rate or a fixed policy loan interest rate. The NAIC task force that drafted the bill recommended that the adopting states might specify 8 per cent as the maximum flexible rate and that this maximum should be independent of the usury laws of such states. The task force report also stated that "a case can be made for a separate, somewhat lower, maximum rate schedule for fixed rate policies, but simplicity of approach favors using the same maximum for both fixed and variable rate policies."

Effective July 1, 1974, South Dakota became the first state to enact the NAIC model bill. The South Dakota version permits either a fixed rate or a variable rate. In either case, the legal maximum is $8\frac{1}{2}$ per cent.

Once again, the news from New York regarding efforts to increase the 5 per cent policy loan rate was not good. Both the variable loan interest rate bill sponsored by Superintendent Schenck and the New York Insurance Department and a "flat 6 per cent" bill were bottled up before reaching the assembly floor.

GROSS PREMIUMS AND DIVIDENDS

Within the past few years, a number of companies (including NEL) have introduced separate dividend scales for policies issued outside New

York and for comparable policies issued in New York, reflecting the respective 6 per cent and 5 per cent policy loan rates and assumed percentages of loan values actually loaned. As I stated earlier, existing case law appears to permit the establishment of separate dividend classes where individuals possess the contractual privilege of borrowing at different policy loan interest rates.

As a matter of fact, it has been suggested that companies are discriminating against non–New York policyholders unless there are higher premium rates or lower dividend scales for New York policies, in order to offset the better policy provisions in New York (e.g., the 5 per cent loan interest rate). Several state insurance commissioners studied this question in 1969 and 1970, and all concluded that companies could use the 5 per cent rate in New York and the 6 per cent rate outside New York without violation of the discrimination laws even if no price distinction was made, either on the grounds that the difference in loan interest rates is not discriminatory or because the antidiscrimination laws of a state are applicable only among policyholders in that state.

SPECIAL POLICIES OR COMPENSATION SYSTEMS

For the past decade or more, many companies have made available one or two HECV policies in addition to their regular nonpension series of permanent policies with relatively low early-year cash values. Often, such HECV policies are characterized by adjusted dividends, or lower first-year commissions and higher renewals, and are sold subject to relatively high policy-size minimums.

In recent years a few companies have radically modified their ordinary products. For example, from 1963 until September, 1973, NEL's entire nonpension series of permanent contracts for $15,000 and higher face amounts was based on relatively high early-year cash values. In September, 1973, the previous series was discontinued and a new series introduced.

With the exception of two forms, this new series was based on relatively low early-year cash values. In the case of the two forms, a $25,000 minimum size was imposed and cash values were based on the minimum surrender charge permitted by the New York Insurance Department.

In designing and pricing this new series, NEL's intent was to isolate, to the extent possible, business subject to planned borrowing from other business. It was our further intent to eliminate previous pricing inconsistencies whereby business subject to planned borrowing was subsidized to a degree by other business.

Thus NEL's regular new policy series is characterized by relatively

low early-year cash values but quite competitive interest-adjusted net costs after ten, fifteen, and twenty years. On the other hand, the two "equity-builder" policies provide maximum early-year cash values but considerably higher interest-adjusted costs, reflecting the high level of assumed borrowing and special persistency patterns attributable to this class of business.

MR. CLAUDE J. MARTINEAU: With the growing importance of the policy loan problem, there is a great need for a study of its source and the proper courses of action that might be pursued to arrive at a safe and equitable solution.

A policyowner could derive various benefits from his policy loan provision. Such benefits are (1) a persistency benefit, (2) an interest rate benefit, (3) an income tax advantage, and (4) an inequity benefit.

THE PERSISTENCY BENEFIT

The basic benefit that a policyowner derives from the use of his policy loan provision is that of persistency. The policy remains in force even if the cash value is borrowed.

THE INTEREST RATE BENEFIT

The policy loan provision should not allow policyowners to profit from a low guaranteed interest rate by creating a liquidity and cash-flow problem for the insurer. Policyowners having rather large loan values are the best candidates for such antiselection. A flexible policy loan interest rate provision should allow the insurer to charge an interest rate high enough to discourage the majority of new loans in a period of rising interest rates, and should offer the possibility of charging an interest rate low enough to discourage the majority of repayments in a period of falling interest rates.

The NAIC model policy loan interest bill, briefly described by Mr. Ingraham, followed an extensive study of the policy loan problem. While the task force stressed the need for uniformity among states, it recognized that the existence of a uniform maximum permissible loan interest rate in all jurisdictions would be somewhat unrealistic.

The New York proposed bill, although apparently a dead issue for 1974, contains a few interesting characteristics which are worth mentioning. It is my understanding that the maximum interest rate would not have been a certain percentage determined at issue but a percentage which could have been revised every year. The insurance contract would

have contained only a description of how this maximum would be determined.

There are twenty-six states that have no specific statutory policy loan interest rate ceilings. Among them are California, Connecticut, Illinois, Michigan, New Jersey, and Texas. It might then be possible to create a special class of policyholders having a variable policy loan interest rate in those states. Possibly a few of the interesting features of the New York proposed bill could be used.

While a maximum interest rate might be necessary, I believe that the maximum should not appear in the policy loan provision itself. It would be better to allow for a flexible maximum which could be changed in any calendar year irrespective of the policy duration.

THE INCOME TAX ADVANTAGE

An advantage that a policyowner could derive by the use of his policy loan provision would be an income tax deduction of the loan interest. Such an advantage encourages borrowing, especially when the interest rate is lower than the usual bank loan interest rate. Excessive use of the policy loan provision for this purpose would produce a liquidity and a cash-flow problem.

A proper illustration of the estate tax disadvantage resulting from borrowing, as well as an effective flexible policy loan interest rate provision, could encourage the policyowner to use his policy as collateral in other financial institutions instead of using his policy loan provision.

THE INEQUITY BENEFIT

A benefit that a policyowner should never derive by the use of his policy loan provision is the inequity benefit. If we compare the relationship between the loan values and the corresponding retrospective asset shares, we distinguish two loan situations. Each situation has its own type of inequity benefit.

The first situation results from policy loans made for an amount not exceeding the retrospective asset share. Such a condition would generally hold true at higher policy durations when the policy loan values are the greatest. In this situation, only nonborrowers from the same class of policyholders could suffer from inequity. There is no inequity in the policy loan provision, since we charge the same loan interest rate on every potential borrower of that class. An indirect inequity is introduced in the policyholder dividends. A portion of each dividend reflects the insurer's earning experience from investment and is applied indiscriminately to all policyholders. No distinction is made between borrow-

ers, who depressed the insurer's distributed earnings, and nonborrowers, who did not. Consequently, it could be said that because of our traditional dividend distribution approach, borrowers benefit indirectly from a net loan interest rate lower than the contractual rate. It is one major reason justifying the proper use of a flexible interest rate provision which could eliminate such inequity benefits in the future. It would be inequitable to introduce another factor in our dividend formula in order to eliminate this inequity benefit. We cannot reclassify policyholders who have been using a contractual benefit if such reclassification is not part of the contractual benefit itself.

The second policy loan situation causing an inequity benefit results from the portions of policy loans that are in excess of the retrospective asset shares. These portions of the policy loans, which I am going to refer to as "the excess loan asset," are provided by funds accumulated by other classes of policyholders. The inequity results from the fact that the insurer is investing such funds in the excess loan asset at a lower earning rate than could be obtained from the insurer's assets excluding all policy loans. The resulting effect is an eventual inequity which will make the providers of such funds bear the cost of this inequitable policy loan benefit.

A portion of the excess loan value over the asset share is sometimes forced on the insurer by its requirements to comply with the nonforfeiture law, but the largest portion of such excess loan value is generally created by the insurer's own initiative when it determines competitive cash-value scales.

The gaps resulting from the excess of the loan values over the retrospective asset shares were not causing serious inequity problems when the new-money rates were about equal to the policy loan rate, but the present unanticipated interest rate situation has generated an unfortunate type of inequity among classes of policyholders.

A legitimate solution to the problem would be to develop series of dividend adjustment factors. These factors could be used to correct the inequity among classes resulting from the effect of unanticipated changes in new-money rates. Such factors would be negative when the loan values were larger than the asset shares and positive when the loan values were smaller than the asset shares.

Another solution would be to reduce the gap between the loan values and the asset shares. The insurer could use a different dividend scale, he could use a different commission pattern, and/or he could modify the contractual benefits in order to increase the asset shares.

The insurer could also use a lower cash-value scale. This is possible

to the extent that these values are not less than the values required by the nonforfeiture law. Perhaps a few changes should be made in the nonforfeiture law in order to determine both minimum and maximum nonforfeiture benefits. Perhaps companies should be allowed to determine lower cash values by using an interest basis independent of the contemplated reserve basis rate in order to make it possible to use a higher interest rate, such as 5 per cent. Another alternative would be to increase the reserve interest rate, but this would be undesirable.

The last two solutions could help the insurer solve the inequity resulting from this last situation, but the proper use of an adequate policy loan interest rate provision could once more achieve this equity goal more effectively, with greater simplicity, and at much lower administrative cost.

It is possible that a better over-all equity could be achieved by the development of new products. The recommended NAIC model variable life insurance regulations provide for a policy loan provision offering the benefit of persistency and possibly the income tax advantage. There is no interest rate benefit and no inequity benefit. Furthermore, the nonborrowers are not suffering any negative impact because of borrowers.

Perhaps we could develop some type of regular life insurance product having features similar to those of variable life. Such a contract could provide at issue a choice of investment medium, such as the general fund including policy loans or a special life insurance fund where the investment-year method could be used. In this situation, we would have an additional class at issue for dividend purposes, or a special type of policy loan provision which would not include the interest rate benefit or the inequity benefit.

We must now, more than ever, eliminate the undesirable features that are causing a slow and agonizing death of our traditional cash-value policy concept.

CHAIRMAN JACKSON: A question that has been raised a number of times is the extent to which specially designed minimum deposit plans have been effective in isolating steady, sustained borrowers. At Phoenix we have had two high-cash-value (HCV) plans for about seventeen years. On our HCV policies of $50,000 or more, 85 per cent of the available loan value is loaned against in durations 12–15. The comparable figure for non-HCV policies of $50,000 or more is 49 per cent, and on non-HCV business under $50,000 only 22 per cent of the available loan value is borrowed against. I do not know how conclusive this is, but there is a definite break by amount of policy in the amount of

loan taken. The sophisticated buyer is borrowing, regardless of what his original intent was, considerably more than the small-policy buyer.

MR. D'ALTON S. RUDD: Recently we looked at the policy loan situation on our business (all Canadian) by reference to the available cash value, thereby excluding equity policies and policies registered as retirement savings plans. For policies subject to a maximum loan interest rate, approximately 15 per cent of the available cash values had loan indebtedness. For policies issued after September, 1968, the figure was 7½ per cent. I believe that we have a responsibility to the participating policyowners within the class subject to a maximum loan interest rate to attempt to devise some system which recognizes those exercising consistent financial antiselection, in contrast to the more usual type of borrowing in emergency situations or in accordance with the automatic premium loan provision. Possibly this might be accomplished by differentiating in the dividend scale between policies which are above and below a certain arbitrary percentage of the cash value in loan indebtedness during the policy year then ending.

NEW FORMS OF GROUP INSURANCE

1. Group legal
   a) What are the considerations and problems in designing contracts and estimating claim and administrative costs?
   b) What is the relationship between lawyer, insured, and insurer?
2. Cafeteria compensation
   a) What is the "cafeteria" approach to fringe benefits?
   b) What are the significant legal, underwriting, actuarial, and administrative problems involved?
3. Group/ordinary
   a) What new approaches satisfy Revenue Ruling 71-360? What is the current attitude of the IRS toward them?
   b) What are the principal markets for this product? What types of products satisfy these markets?
   c) Has any meaningful mortality or termination experience developed?
4. Survivor income
   a) Is this product too sophisticated for the typical buyer? What are the principal markets? What plan design best satisfies these markets?
   b) What actuarial assumptions are used? Are remarriage discounts used, and does experience justify them?
   c) What are the tax implications for employees?

Dallas Regional Meeting

CHAIRMAN THOMAS A. BECKERT: Looking at the topic we are to discuss, one might question the use of the words "new forms." Certainly group ordinary and survivor income have been discussed and reviewed from every angle at most industry meetings for a number of years. However, today, because of revised revenue regulations and new marketing techniques, we find renewed interest in these products. The other two topics, group legal and "cafeteria" compensation, also are not really new in the marketplace but are new at least as far as discussions at Society meetings and other employee benefit–type meetings are concerned.

Group legal is a subject that has not received much attention at Society meetings in the past, and yet the extent of some of the group legal programs and the work that has been done in this field are very impressive.

Cafeteria compensation is a more recent development in compensation philosophy and administration that is bound to receive much attention.

It could very possibly gain an acceptance in the field of compensation that will cause it to "catch fire" as a marketing device.

Group ordinary is a topic with which most of us who attend these meetings regularly are very familiar. It continues to be of interest because of recent changes in revenue rulings, which have resulted in new marketing approaches such as the use of individual policies especially designed for this market.

Survivor income has been labeled as a sophisticated, hard-to-understand product by some, and this may be the reason a number of group-writing companies have avoided developing the product. But with group insurance being used today by many as part of the estate planning tool, this product is once again receiving more attention.

MR. JACK A. ROLLIER: Perhaps the greatest impetus for the developing interest in group legal insurance has been the advancement of the theory that there is a great number of Americans, somewhere in the neighborhood of 140 million people, who do not seek the legal services which they need. Concomitant with the recognition of this unmet need are two other developments which have added momentum to the movement. One is the support of the organized bar, which previously had taken a negative view toward closed-panel plans, which they considered unethical. The other is the recent amendment to the Taft-Hartley Act permitting employer contributions to fund group legal plans. As the matter now stands, such contributions would be taxable income to the employee, but it is expected that the Internal Revenue Code will soon be amended to have such employer contributions exempt from taxation, as contributions to health care plans are now.

Now that the need for legal services has been recognized, development of the mechanism to deliver such services to the potential clientele is the next step. Prepaid legal service plans are thought to be the most efficient way to accomplish this. Prepaid legal services are defined as a system in which the cost of such services needed in the future is prepaid by or on behalf of the client who receives such services, usually offered on a group basis. The mechanism by which services are provided consists of a panel of lawyers, designated either as an "open panel" or as a "closed panel." The closed-panel approach usually means an employee group or a labor union which retains a single lawyer or a firm of lawyers to represent its members on an individual basis. In order for the member to take advantage of the benefits, he must use one of the lawyers on the closed panel. Open panels, on the other hand, offer a free choice of lawyers, which might be comparable to the free choice of a doctor which is offered by

group health insurance policies. It appears that most of the insured group legal service plans use the open-panel approach, whereas many of the noninsured plans are going the closed-panel route.

The contract under which fees for legal services are insured is not unlike a group health insurance contract. There are definitions as to who is eligible, who is a dependent, claim procedures, provisions for termination of the contract, entire agreement, conformity to statute, nonassignability, and change, and in one contract I saw a rather unusual provision calling for arbitration of all controversies arising pursuant to the terms of the policy. Before arbitration begins, each party must pay an equal share of the estimated cost of arbitration. The benefits provided may be as extensive as the amount the policyholder has available to fund them.

There is usually a schedule of benefits which lists the various services provided and the maximum amount payable for each service. There is a basic hourly rate specified for general consultation and advice, along with a maximum number of hours of consultation available per month and per year. Available services might cover adoption, probate proceedings, bankruptcy, wills, real property foreclosure, debt collection, criminal defense, defense in small claims court, and marital relations. It is common to have a deductible on some of the more expensive benefits and to have a maximum aggregate payment for each insured family in any policy year. Excluded charges might be for preparation of income tax returns, business ventures, or patents.

The general pricing approach seems to be very straightforward. After deciding on the benefits to be provided, an estimate is made of the cost of each service, taking into account usual and customary charges by legal professionals in the area in which services will be rendered. Estimates are also made of rates of utilization of the services by the population to be served. Then it is a matter of taking the product of utilization rate and cost, and summing these to arrive at a claim cost. After adding margins for expenses, overhead, and profit, premium rates are derived. The key to accurate pricing would seem to be the utilization rates used in the pricing structure. Such rates probably will vary among population groups according to socioeconomic levels, geographical location, and other factors. A further problem is that even an accurate appraisal of the past may not give a true picture of what the future holds, since the existence of the insured plan may change patterns of use.

Legislation has been enacted or pending in several states authorizing the formation and operation of nonprofit corporations whose purpose is to establish a plan of prepaid group legal services. The legislation in most cases has provided for regulation of such corporations by the insurance

commissioner in consultation with the state bar association. Other points included relate to approval of rates by the commissioner and a requirement that such corporations operate on the open-panel system. States enacting or considering legislation include California, Connecticut, Hawaii, Massachusetts, Minnesota, New York, Oregon, Texas, and Washington.

Up to this point, there has been almost no activity in the area of insured group legal service plans actually being written. Most of the plans to date have been written by companies with casualty charters. However, with the more favorable legislative environment that is developing, we can expect a continuing and growing interest in this brand new field.

MR. EDWARD W. MARONI: My remarks will deal with the cafeteria approach to benefit selection.

I. CONCEPTS AND DEFINITIONS

In its broadest sense, cafeteria compensation can be defined as a total compensation program which allows each individual the opportunity to make selections with regard to all items of compensation. These would include salary, bonus, time off with pay, perquisites, pension and profit-sharing plans, group insurance coverages, thrift and savings plans, vacations, stock options, and so on. Using the term in this sense, we probably are talking about an idea that has been discussed and analyzed for, at the very most, a decade.

If we define "flexible benefits" as encompassing the same basic principle of allowing an individual employee a choice as to how he receives his compensation, but excluding any choices related to receipt or nonreceipt of cash, or choices which would cause disqualification of qualified plans, then we are really talking about choices among time off with pay (special purpose); perquisites; group insurance coverages, as, for example, accidental death and dismemberment, health (traditional coverages), dental care, eye examinations, full psychiatric care, disability (long- and short-term), and prepaid group legal and nonqualified deferred compensation plans. This is an idea that has been around for decades. In fact, many employers have permitted their employees, especially executives, to make optional supplemental benefit elections for some time.

Several companies have given significant study to the cafeteria compensation idea in the broad sense, as we have defined it above, but generally they encountered problems that were considered so severe that they either dropped the idea or switched to the more limited concept of flexible benefits.

II. SIGNIFICANT PROBLEMS

Legal problems include the "doctrine of constructive receipt"; the entire body of law surrounding the qualification of pension, profit-sharing, and other such plans; and "legal liability" for providing poor advice resulting in financial loss to the advisee or his beneficiary.

Frequently noted underwriting problems involve antiselection (both physical and financial) and the possible need for new rating methods.

Actuarial problems involve pricing, valuation, the establishment of pooling and reinsurance limits, and the need for more intensive and frequent study of external forces.

From an administrative viewpoint there are problems concerning the decision-making process with regard to which options will be provided, and the establishment and maintenance of individualized total compensation information far beyond that to which employers are now accustomed.

III. BUSINESS AND SOCIAL IMPLICATIONS

Those companies that have researched the idea have repeatedly identified communications and computerization as the two big areas which need to be developed in order to effectively implement cafeteria compensation.

The point has been made that both employer and employees must participate in developing the structure of the program in order to develop the trust on the employee's side, and the confidence on the executive's side, necessary to make cafeteria compensation work. However, as I see it, the most critical aspect of implementing a cafeteria program will be the communications process required to teach the employee what his choices are and the implications thereof. The vastly increased complexity of this type of coverage over what is currently available will require the following:

1. Generalized descriptive material
2. Group meetings led by highly trained leaders
3. Individual counseling
4. Opportunities to make at least one preliminary set of choices as well as a "final" choice at inception of plan
5. Opportunities to change the original set of choices
6. Individual employee benefit statements of a more personally tailored nature

In my opinion the challenge to the communications people will be enormous, exciting, and, upon production of good results, very satisfying.

The need for sophisticated computer software systems is self-evident. Tailor-made individual information will be required on a cyclical basis

as well as on a demand basis. A smoothly functioning computerized human resources information system (HRIS) would seem to be a prerequisite to the development and effective operation of any reasonably broad-gauge cafeteria compensation system.

Choices made by various groups of employees may well surprise management; the demographic characteristics of a group may not predict the benefit profile of their selection group. In other words, management will not, and should not, try to rely too heavily on the demographic characteristics of their employee groups or on their own preconceived notion as to what will be selected. I believe firmly that, given the opportunity to make an informed choice, almost everyone will make an intelligent choice, and it will be a more intelligent choice for him as an individual than one imposed on him by his company.

IV. CONCLUSION

Cafeteria compensation has experienced a rather severe setback due to the Internal Revenue Service "doctrine of constructive receipt" position. The qualified plan tax code, regulations, and rulings put severe limitations on the options available for qualified plans. However, I feel that, as a result of new forms of benefits and new techniques for providing them, modifications in the legal environment, and greatly increased use of options that are currently available but seldom used, more and more choices will be made. Common sense seems to tell us that the rising expectations of people in general, particularly the young, the increasing educational levels, and the increasing impact of external forces such as social security, health maintenance organizations, and a high rate of inflation will require that total compensation techniques become more responsive to the need for rapid, meaningful change. Obviously, cafeteria compensation as defined earlier is not "right around the corner," and we probably will not see any dramatic single change, but I for one believe we are headed there.

MR. TED L. DUNN: At this time, the primary marketing strategy appears to be directed toward the development of group ordinary markets among small groups, with only a very few insurance companies expressing interest in the large-group market. The approaches being used depend on the particular combination of the following four factors:

1. The death benefit can be either a level or an increasing amount.
2. The employer contribution can provide either a level or a decreasing amount of term insurance.
3. The plan can be provided by a group policy, by an individual policy with a

rider, or by two individual policies. Under section 79, the IRS requires that individual policies be treated as a group plan.

4. The employee contribution for a group ordinary plan goes to purchase the permanent values of the plan.

Some of the approaches which are currently being used are:

1. The Republic National has received IRS approval for an arrangement using two individual policies. This approach permits a large amount of flexibility with regard to split-dollar plans, deferred compensation arrangements, buy-and-sell agreements, and the like.
2. The Security-Connecticut has received IRS approval for the use of an individual policy with a rider.
3. Manufacturers Life has received IRS approval for a term policy with an increasing death benefit. It is of interest that Manufacturers is a participating company, and I understand that dividends are available on both the basic term policy and the increasing death benefit.
4. The Lincoln National approach also consists of adding an increasing death benefit rider to a term policy, and IRS approval is anticipated.
5. Group products are marketed by a number of companies, including Ohio National, Crown Life, Western Life, and Provident Life and Accident. The coverage may be written as a conventional group life insurance plan on a single employer, or, as is currently being done in a number of instances, it may be marketed through a multiple-employer trust, with a group policy being issued to the trust. In order to provide greater flexibility, the situs of the trust would be in a state which has neither a maximum-amount limit on group life insurance nor any minimum requirements as to the number of lives comprising a group.
6. The group ordinary product offered by the Provident Life and Accident to small groups is written through a multiple-employer trust and gives the employer a choice between a level death benefit and an increasing death benefit program. The employee premiums and policy values are the same under both plans. Under the level death benefit plan, the employee's premiums buy amounts of paid-up insurance, and the employer's annual renewable term premium is applied each year to a reducing amount of death benefit. Under the increasing death benefit plan, the death benefit increases by the amount of paid-up insurance purchased by the employee's premiums, and an amount equal to the initial face amount is purchased by the employer's annual renewable term premium. If reducing the employer cost is of primary importance, then the level death benefit plan is suggested. If, however, maximizing benefits and the employer deduction are of primary importance, then the increasing death benefit plan is suggested.

Waiver of premium for both the term life coverage and the permanent coverage is available for issue ages through 55. The waiver of premium benefit is elected by the employer and applies to all the coverage for his eligible employees. The employer contributes the additional premium for

the waiver benefit. Accidental death and dismemberment benefits are also available as supplementary benefits.

The permanent arrangement for small groups includes the usual type of ordinary life insurance policy loan provision.

There are five principal markets for group ordinary products designed for small groups:

1. The professional corporation with one or more employees.
2. The small, closely held corporation with one or more employees.
3. The superimposed market—this usually consists of a carved-out group of specified eligible employees, with the coverage superimposed on an existing group life plan covering ten or more employees.
4. The standard employee benefit market, providing the advantages of the group ordinary concept to employees of employers generally.
5. Money-purchase pension and profit-sharing market, providing group term insurance to employees along with the permanent option as a fixed-dollar investment of the retirement plan trust.

The mortality experience which will emerge on group ordinary products will be substantially affected by the extent of the underwriting which takes place at issue. Typically, a simplified nonmedical application would be used for coverage up to $10,000 for applicants through age 55. For higher amounts of insurance through age 55, up to $40,000 or $50,000, a full nonmedical application would normally be taken. Regular individual ordinary life underwriting rules would usually apply for insurance outside these limits. Although eligibility for coverage or the amount of coverage will be determined in the home office on the basis of the nonmedical examination questionnaire, full medical examinations for higher amounts of insurance will typically be ordered subsequently to determine the actual premium rate to be used for the applicant. Any additional premium resulting from a special class rating is generally paid by the employer, is tax-deductible to him, and is not taxable income to the employee.

The termination experience which develops may be significantly affected by the eligibility requirements for the permanent insurance. Thus a different termination experience would be anticipated for plans providing permanent insurance immediately for all employees, as compared with plans having a waiting period of two years before employees become eligible for permanent insurance.

MR. ROBERT C. BENEDICT: Is the survivor income benefit too sophisticated a product for the average buyer? Is the product any more sophisticated than a medical expense benefits plan which provides $50

room and board up to a maximum of 120 days with $3,000 of ancillary charges, a $1,200 California Relative Value Schedule surgical schedule, physicians' visits benefits at $5 per visit to a maximum of $350, diagnostic X-ray and laboratory benefits to a maximum of $500, supplemental accident benefits of $500, and superimposed comprehensive with a $100 deductible, with 80 per cent of covered expenses up to $5,000 in any calendar year and 100 per cent thereafter, and with a lifetime maximum of $250,000 of benefits? I would say, "No." The point is that survivor income benefit, like any new product, is unfamiliar. The far greater sophistication of the typical medical expense benefits plan is something we either have grown up with or have been forced to assimilate because the policyholder was already *familiar* with it. Moreover, the policyholder *needed* the medical expense benefits plan, whereas he must be convinced of the need for survivor benefits. So there is an education process to be pursued—education of the policyholder as well as of the broker or salesman—before this product can be sold.

My second semantical objection to the question, as presented, is that it does not state whether it refers to the typical group insurance client or to the typical survivor benefits prospect. There is a difference, I maintain. Survivor benefits came in through the unions and have, to some extent, been accepted by the large, sophisticated policyholder. The typical group insurance client, on the other hand, has not been "red-hot" on this product.

Just one more comment on this sophistication angle. If someone objects to the "sophistication," you can point out that group term life is a survivor benefit! After all, the concept of settlement options has been around for years, and a survivor benefit is nothing more than a settlement option with one little twist—the emphasis is on income rather than face amount.

In answer to the question as to what are the principal markets for survivor income benefits, one might say that quite typically the first prospects are usually in-force policyholders, especially those with a desire to improve benefits for younger employees or with the objective of hiring and retaining top young executives. For the policyholder who wants to upgrade benefits for his younger employees, a spouse benefit to age 62 or age 65 plus a child's benefit to age 19 or age 23 usually does the job. This is in contrast to a plan where an attempt is made to dampen the characteristically greater benefits at the younger ages by eliminating the children's benefits or limiting the duration of spouse benefits to a maximum of ten or even five years. Cost is often an overriding or at least a contributing factor, in which case either the benefit duration or the

benefit percentage is limited, depending upon whether the client wants the coverage to be tilted in favor of older or younger employees, respectively.

Historically, the market was opened by the unions with the UAW bridge and transition benefits. From there it spread to the larger employers, which is the sector of deepest penetration thus far. Some carriers have had success with smaller policyholders, and the medium-sized policyholder seems to be the last to jump on the bandwagon. Groups dominated by white-collar or higher-paid blue-collar employees have yielded more success for some carriers.

Plan design is primarily a function of cost and policyholder philosophy. If cost is a limiting factor, then the policyholder must decide whether he favors limiting the benefit percentage or duration. Of course, for the policyholder with a group term life earnings plan who wants to adopt a survivor benefits program without any increase in cost, a portion of the group term life plan can be carved out and converted to survivor benefits. Most recently, there has been a demand to make survivor benefits more like settlement options, with employee choice of option type and/or the beneficiary. The problems of selection and antiselection attendant upon such employee choices are obvious.

What actuarial assumptions might be used? For interest a rate approaching the new-money rate might be acceptable, perhaps coupled with a descending scale—for example, 8 per cent in the first year, decreasing by $\frac{1}{4}$ per cent each year thereafter to an ultimate rate of 6 or $6\frac{1}{2}$ per cent. Population mortality experience is probably better than experience under insured lives, unless dependent life data are available in the required detail. Age spread is based on differences between employee and spouse ages. These must, of course, be varied by sex and could also be varied by age of employee. In some instances it may be necessary to have a standard distribution of employees by age. Of course, where survivors' date-of-birth information is unavailable, the proposals should be qualified to permit a redetermination of rates at issue.

Are remarriage discounts used, and does experience justify them? Remarriage discounts are not justified by experience, but the experience is still too scanty for any firm conclusions. As far as I know, the social security and Railroad Retirement Board tables are the only ones used for remarriage rates.

What are some of the tax implications to employees on account of survivor income benefits? In what follows, when I speak of an "amount of insurance," I am referring to the present value of the survivor benefits payments. The assumption is that survivor benefits can be treated as an equivalent amount of life insurance under section 79, and that the phrase

in that section which states that the present value should be based on the mortality table and interest rate employed by the insurer" can be extended to the use of remarriage discounts as well. Federal income tax may be payable by the employee on the income imputed from larger amounts of insurance. Amounts of insurance less than $50,000 are generally exempt, and the imputed income is reduced by employee contributions. Federal income tax, therefore, is most often generated for the older, higher-paid employees, especially if there are substantial employee contributions. In applying the section 79 exemption and rates, note that amounts in excess of the state maximum do not come under that section; rather, they are taxed under section 61, which has higher costs.

Federal estate tax would also be payable at the death of the employee, if the amount of his survivor benefits exceeds his estate tax exemption. The assumption again is that the present value of survivor benefits would be treated the same as a comparable amount of group life insurance. A valid assignment of all rights or incidents of ownership under the survivor benefits plan may permit the exclusion of the present value of the benefits from the employee's gross estate. If a spouse's benefit ceases as a result of death or remarriage, then (1) the present value of the children's benefit is not includable in her estate and (2) there is no refund of any estate tax paid, even though a much higher present value was included in the gross estate than was collected in total payments. The converse is also true.

There may also be state inheritance tax to the survivors and a tax on interest payments in excess of $1,000, calculated by means of an exclusion ratio.

Montreal Regional Meeting

MR. E. JOHN WOOLSEY: Group legal insurance is a coverage which has gone through the initial development stages during the last five years. It is designed to meet the needs of middle-income families for legal advice and counsel. These families, which are roughly defined as having incomes between $6,000 and $16,000 per annum, constitute about 70 per cent of the North American population. The top 10 per cent of the population has always had access to good legal services. The bottom 20 per cent now has at least some access to legal services through the various state and provincial legal aid plans. There is a largely unmet need among middle-income families.

In June, 1972, the Becker Research Corporation conducted a poll among Massachusetts residents on behalf of the Massachusetts Bar Association. The results of that poll are interesting.

1. 58 per cent of Massachusetts residents bought or sold their houses, but only 38 per cent used professional legal services in connection with the purchase or sale.
2. 46 per cent made large purchases on the installment plan, but only 9 per cent used legal experts to review their contracts.
3. Only 33 per cent have wills, and only 31 per cent had the advice of attorneys in connection with their wills.

The increasing complexity of the law indicates an increasing need for legal services. What is the reason for this unrecognized and unmet need? Various studies and surveys indicate that the greatest barrier between lawyer and client, in the middle-income bracket, is the fear of the costs of legal services. The second largest barrier is the unfamiliarity of the average individual with lawyers and his consequent inability to select a lawyer. Group legal plans are an attempt to surmount these barriers. Most plans call for a membership charge or premium which in effect prepays future legal services, thus eliminating the fear of cost as a barrier. Since the group plan either employs or recommends the attorney, the second barrier, the lack of knowledge of which attorney to select, is removed.

There are three strong forces behind the development of group legal plans. Unions are interested in bargaining for this form of benefit for their members. Section 302 of the Labor Management Relations Act, 1947 (Taft-Hartley), was amended on August 15, 1973, to make legal services a subject for collective bargaining. The various state bar associations are interested. The approximately 300,000 lawyers in the United States are expected to double in number during the next decade. Many of the new lawyers will go into private practice, and middle-income families represent a largely untapped market for their services. Also, group legal benefits may replace the loss of legal fees due to no-fault auto insurance. Insurers see group legal as a new source of income and as a partial replacement of expected loss of premiums due to national Medicare.

There is as yet no standard design for group legal plans. They tend to be structured in a manner similar to that of dental insurance, with basic benefits, major expense benefits, and specialty coverage benefits. One possible plan design provides the following four standard benefit groups:

1. Basic benefit—covering consultation and advice, conferences, negotiations, letter-writing, will and document drafting. This benefit might have a deductible of $25 and a $300 family maximum per annum.
2. Litigation benefit—covering expenses for hearings, trials, motions, or court appearances which are related to trial courts, administrative boards, or arbitration panels. Maximum benefits would be based on a fee schedule.

3. Major expense benefit—covering catastrophic losses and supplementing the litigation benefit. This would provide broader coverage than the litigation benefit. It would have both coinsurance and a maximum benefit limit.
4. Domestic relations benefit—covering benefits exempted from the other three groups, such as divorce, separation, support, child custody, and other legal problems arising from marital relationships. This last benefit is probably the most expensive.

Group legal plans usually have a number of exclusions designed to avoid unreasonable use of the plan and to avoid conflicts of interest, such as litigation between two covered members of the plan or between an employee and the employer.

One problem, which has caused considerable heated debate, concerns the delivery system. There are two basic types of delivery plans: the "open-panel" and the "closed-panel" plan. They differ in the manner of selecting the lawyer. Under open-panel plans the covered member of the plan has the freedom to select any lawyer. Under closed-panel plans the participating lawyers are preselected by the group. The distinction between the two systems is not always clear. Under an open-panel plan the covered member may seek the guidance of the group in selecting a lawyer, thereby creating a de facto closed-panel system.

Open-panel plans are generally acknowledged to be more expensive. There are at least four ways in which closed-panel plans can potentially render higher-quality legal assistance than open-panel ones.

1. Costs can be spread across a larger client base than in the case of individual law offices. A closed-panel law office could maintain better law libraries, office equipment, and other support services for lawyers.
2. Smaller open-panel offices, faced with a greater overhead expense per client, are under greater pressure to allocate their efforts to each case according to its income-yielding potential.
3. It would be extremely difficult and costly to monitor or upgrade the performance of a panel including all or most attorneys in an area. It would obviously be much easier to do so in a closed-panel program.
4. Since a group legal services staff would handle legal problems peculiar to the beneficiary group on a high-volume basis, it would soon develop greater expertise in these legal problems than would open-panel attorneys to whom work was randomly distributed.

There are problems with closed-panel plans. The panel may find it difficult to reject a case which it feels is without merit. There may be political problems among the union, the lawyers on the panel, and the employer. The panel may not be able to handle the unusual cases.

Various state bar associations and the American Bar Association have

been strongly opposed to closed panels as being in conflict with their Code of Professional Responsibility. The conflicts relate to a lawyer aiding a nonlawyer in the unauthorized practice of law, a lawyer forming a partnership with a nonlawyer for the practice of law, advertising of legal services, and the possible direction by a nonlawyer of a lawyer's professional judgment in rendering legal services.

There is still some question as to the tax status under the Internal Revenue Code of group legal premiums and benefits. The majority opinion of interested parties is that employer contributions are reasonable and necessary business expenses and deductible from gross income; employer contributions are taxable income to employees, and benefits paid are not taxable income to employees. There is no consensus on employer contributions to section 501(c)(9) trusts. These might be allowed if the Internal Revenue Service accepted group legal as one of the "other benefits" which such trusts may provide. Such a decision is likely, now that section 302 of the Taft-Hartley Act has been amended.

To my knowledge, there are at present no group legal plans in Canada. I spoke over the telephone with the Department of National Revenue about the taxation of such plans. Their response, which was qualified as being "off the top of their heads" and unofficial, was that the income tax act provided for the same taxation as that described earlier under the Internal Revenue Code.

Should group legal plans be subject to insurance regulation? Most states have statutes which limit the types of business that insurance companies may write, and none include group legal among the permitted types of business. An insurance contract is usually understood to be one for indemnity against loss, damage, or liability from a contingent or unknown event. It would appear that legal services in the preparation of wills as well as advice in connection with personal contracts and drafting of documents do not arise out of a contingent or unknown event. This may not be materially different, however, from dental insurance. Coverage afforded for either civil or criminal proceedings brought against the insured in a court are of a contingent or unknown quality.

The insurance commissioners are divided about whether group legal plans constitute insurance. The tendency is to find such plans within the jurisdiction of the insurance commissioner. In many states enabling legislation is required. Such legislation has become controversial because of efforts made to limit the insurance coverage to open-panel plans or to provide that where the plan is sponsored or approved by a bar association it is exempt from the jurisdiction of the commissioner.

Another hazard has appeared in the form of the Antitrust Division

of the United States Department of Justice. The department has shown increased interest in the past few years in the whole area of professional fees. With respect to lawyers' fees in particular, the Justice Department has indicated that it feels that the minimum-fee schedules published for many years by many local bar associations may be in violation of the antitrust laws. While this interest by the Justice Department has been directed mainly at minimum fees, at least in theory efforts by providers to regulate maximum fees may be almost as vulnerable to attack under the antitrust laws.

There is little published information on the incidence of claims under group legal insurance plans. Insurers and service organizations active in the field do not yet have extensive statistical information on claim costs. In addition, they have an understandable reluctance to publish information derived from a considerable investment in research and development.

There are a significant number of group legal plans now in force. California is probably the leader in this field. By the middle of 1973 there were more than four hundred group legal service programs embracing some one million participants registered and operating in California. The State Bar of California has formed the California Lawyers' Service, a unique corporation specifically authorized by the California legislature, to operate and administer a statewide system of prepaid legal services. Similar organizations are contemplated in other states.

There are a number of other plans which have received some publicity. One is the Shreveport Bar Association plan in Shreveport, Louisiana. This is a pilot open-panel plan sponsored by the American Bar Association and funded in part by the American Bar Association, the American Bar Endowment, and the Ford Foundation. It covers approximately five hundred members of Local 229 of the International Laborers Union. The majority of the states have at least one plan either in operation or under active consideration.

The challenge to the insurance industry is to use its financial and human resources to lead in the development of group legal coverages. If the industry does not respond quickly, leadership will be provided by bar associations, unions, and other groups.

MR. JEAN-PIERRE PROVENCHER: The "cafeteria" compensation approach can be defined as the individual designing of a compensation package, considering the special needs, desires, and circumstances of a particular employee. The key elements of cafeteria compensation are flexibility, since a wide range of options is available, and employee involvement, since each employee designs his own compensation package

as opposed to the traditional employer-determined package. The concept of true cafeteria compensation implies that salary and benefits are treated as a total package. The purpose of this approach is not to increase the cost of the total package but rather to rearrange the elements of the package so as to maximize the compensation for a particular employee in the light of his own particular situation. A 25-year-old bachelor, for example, might prefer to take the company's contribution to the pension plan in cash, while a 50-year-old married man will prefer to have the money directed to the pension plan.

The cafeteria approach can take several forms:

1. The pure concept applies to a compensation program in which the employee has the opportunity to choose on a before-tax basis all items and forms of compensation. A set of relative values for each form of compensation is predetermined, and the employee is then allowed to make his selection subject to an over-all maximum.
2. The cafeteria approach can also be limited to benefits only. The benefits can be made available on an after-tax basis, which means that the employee designs his benefit package considering the availability of a particular benefit and the amount of money he can afford to spend after tax. Some programs on that basis are already in existence to a certain degree. Some plans provide, for example, that an employee can elect to have optional group life insurance for one, two, or three times his salary.

   The benefits can also be made available on a before-tax basis, as in the pure concept. Instead of complete freedom in the choice of the various benefits, the employee can also be offered certain predesigned packages in order to reduce the endless number of possible benefit choices.
3. Another form of cafeteria compensation would be a choice limited to a certain sum of dollars that can be spent according to the employees preferences, the sum coming from such sources as a bonus or a salary raise.
4. Other limitations can be introduced in terms of eligibility of the employees, such as those for executives only.

Why would a company or an employer consider the cafeteria approach to compensation? Employee benefits have been regarded for quite some time as dissatisfiers. In general, the dissatisfaction comes from the paternalistic attitude of the employer. The majority of employee benefits are determined unilaterally by the employer and are aimed at covering an "average" employee. Some experts feel that the employee who has the freedom of determining his own benefit package will feel happier, will have a better attitude toward the employer, and will be more interested in the work he is doing.

The concept of the cafeteria approach to compensation presents some

very attractive elements. However, there are several problems that have to be looked into before a particular corporation can seriously consider the cafeteria concept:

1. One area is the administrative complexity of the cafeteria concept. In its pure form, the cafeteria approach will result in endless combinations of choices by individuals. In order to accommodate these various combinations, the corporation will have to make extensive use of its computer resources. The development costs associated with this concept will be enormous. However, it is likely that this will still be a small percentage of the total amount of money spent on the benefit package.
2. A second area of difficulty is taxation, particularly with respect to the problem of constructive receipt. Basically, an individual is construed to have received income if there are no substantial restrictions as to his control. Some consultants feel that if the election is made prior to the receipt of benefits, it might be possible to avoid the situation where the whole amount of money available for compensation would be treated as received income. It has been suggested that the cafeteria approach to compensation might be the spark to initiate a reform of the taxation of benefits by the IRS. An application of the true concept of cafeteria compensation would also create some problems with regard to the qualification of pension plans. If a large number of the younger employees of a corporation elected not to participate in the pension plan, it could be ruled as discriminatory and lose its qualification status.
3. A third area of problems deals with the legal difficulties. What would happen if an individual opted out of group life insurance and died a few days later? There could be room for legal liability to the corporation. A solution to this problem might be for the corporation to provide a common base of benefits to all the employees. By going this route, however, the employer is diverting from the true concept. There could still be the possibility of legal liability for wrong choices. Individual counseling will be important to the employees. The corporation itself will have to be extremely careful as to what it provides to its employees through educational written material and meetings. Outside counselors will probably be required by the executives, since they will be very reluctant to share personal facts with another employee.
4. The fourth area of difficulty lies with the insurance companies. Traditionally, insurance companies have required minimum percentages of participation in the area of 75 per cent. Obviously, if a program of true cafeteria compensation is adopted by a particular corporation, it might not be possible to realize 75 per cent participation in each and every coverage. The insurance carriers would be open to antiselection. If an employee has the option of retirement income benefits, additional life insurance, or dental coverage for his children, he is going to select the last choice if his children have bad teeth but the second choice if he has bad health. Also, it is going to be almost impossible for the underwriters to offer the options at an agreed-upon rate.

This rate would be properly determined after the enrollment, when the underwriter knows what kind of people and how many have elected to participate in a particular coverage. The determination of appropriate levels of benefits which are traditionally related to salary, such as long-term disability and pension benefits, will present an interesting challenge if an employee is free to determine how much he will receive as salary.

5. Finally, not the least area of concern is communication. A great deal of communication will have to be made in order to acquaint the employee properly with this new concept. In the past the employees never had to learn too much about their various forms of benefits, having no say in their participation. Now they will have to. The employees also have to be given information about the relative values and costs of the different benefits. There is also the question of the ability of employees to make wise judgments.

MR. WILLIAM M. ROTH: Law Opinion 1014 (1920) stated that, while premiums paid for group life insurance constitute proper deductions under the heading "ordinary and necessary expenses," they do not constitute additional income to the employees whose lives are insured and are, therefore, not required to be reported "as income" by such employees.

In 1950, Mimeograph 6477 dealt with the treatment of group permanent and made it clear that the favorable consequences of Law Opinion 1014 were never intended to go beyond term protection. This mimeograph held that employer contributions for nonforfeitable permanent insurance constituted additional income to the employees. So called group paid-up insurance with separate premiums specified for the term and paid-up portions where the employee paid for the paid-up insurance, was not affected by Mimeograph 6477—no part of the employer contribution for term insurance constituted additional income to the employee.

Section 79, adopted in 1964, restricted the previous blanket exemption for group life premiums to premiums paid by the employer for the first $50,000 of coverage. With respect to group ordinary, the regulations state: "In the case of a policy which includes permanent insurance, a paid-up value, or an equivalent benefit, Section 79 shall apply to that portion of the insurance provided thereunder during the taxable year which constitutes group-term life insurance (within the meaning of this paragraph) only if the policy specifies the portion of the premium which is properly allocable to the group-term life insurance, and no part of the premium which is not so allocable is paid by the employer."

Revenue Ruling 71-360 ruled out the level employer premium approach by holding that a "premium is properly allocable to the group-term life

insurance if the employer's payment per $1,000 of current insurance protection increases each year with the attained age of the employee and is determined by realistic mortality, interest, and other assumptions. A premium is not properly allocable to group-term life insurance if it is a level premium, or if the rate per $1,000 of term protection varies with the duration of some form of permanent insurance policy issued to conjunction with the term insurance protection or with the age at issue of such a permanent insurance policy." Further, the ruling provides that "any dividends or rate credits for the group-term insurance, or the permanent insurance, will be determined independently of each other." The ruling also states that "the premium loading for expenses allocable to the employee's permanent insurance must be included in the employee's share of the premium."

Peter Cooper of the Occidental wrote an excellent paper on section 79 which appeared in the American Life Convention *Legal Proceedings* (1971). There is also extensive discussion on subsequent rulings in the 1973 *Transactions* (XXV, D155).

I also have fairly good information that the IRS does not plan further rulings at this time, with one exception—they are looking into the underwriting rules for the under-ten-life cases, and expect to have something out in the next six months.

As I interpret the final regulations of December, 1972:

1. For both old and new plans that have a problem or an improper allocation, any employer contribution in excess of the allocated term premium results in the total employer contribution being taxable income to the employee.
2. The grandfather clause for policies in force on December 21, 1971, permitted, for tax years beginning before July 1, 1973, an improper allocation to result in a section 79 treatment—that is, no taxable income to the employee on less than $50,000, and Table of Uniform Premium treatment on the excess.
3. For policies written after December 21, 1971, and for tax years beginning after June 30, 1973, for policies in force December 21, 1971, an improper allocation results in taxable income to the employee only to the extent the employer contribution is in excess of the proper allocation. Again, the employer contribution gets section 79 treatment to the extent of the proper allocation.

As to "what is a proper allocation," this is determined in an actuarial bureau in Washington, and here is my impression of how they operate:

1. There should be a separate schedule of benefits and premiums in the policy, and certainly this would be satisfied by two policies or a policy with a rider.
2. IRS actuaries might calculate a net premium on the basis of modern mor-

tality and graded interest rates for both the permanent and the term portions. The gross premiums of the company would then be compared to the net premiums they have calculated. If they turned out to be the same, there would be no problem. If the permanent net premiums were more than the permanent gross premiums, and the reverse were true for the term premiums, this would probably be regarded as improper allocation. However, if the permanent net and gross premiums were equal, and the term gross premiums were higher, there is some chance it would be approved on the basis that it can be argued that most of the expenses are attributable to the term portion of the contract. I get the impression that the IRS is more interested in a correct allocation of interest and mortality than in expenses.

3. A mutual company which wrote the term on a nonparticipating basis, and the permanent on a participating basis, would have IRS problems.

I have always been opposed to our company's writing any kind of group ordinary on all employees. Here are some of the problems:

1. How does one generate a group ordinary pricing structure which will be reasonably competitive with the company's regular line when there is no underwriting? It is hard to buy the concept that one should be willing to write ordinary without underwriting if one writes group term without underwriting. The objective is to have the employees keep the policy in force after termination of employment, and it seems unfair to expect this if the employees end up with a substandard product. If it is not substandard pricewise, who shares the loss?
2. Lapse rates are horrible, as might be expected, and I do not see how a company can avoid substantial losses if it uses anything like the normal commission structure. One company furnished me with lapse and conversion rates. Let me present a few excerpts from its figures:

LAPSE RATES (INCLUDING CONVERSIONS AND AUTOMATIC CONVERSIONS)

Issue Age	Year				
	1	2	3	4	5
Under 20	78.7%	52.7%	40.2%	21.2%	0.0%
20–29	44.7	28.4	22.3	18.8	14.9
30–39	26.9	21.4	14.2	15.2	7.7
40–49	13.6	15.3	11.2	13.7	9.2
50–59	14.6	12.5	9.6	11.4	9.2
60 and over	11.3	10.5	12.7	12.3	4.9
All ages	25.2%	18.1%	12.7%	13.9%	9.0%
Exposure (amount in 000)	$201,604	$142,465	$95,622	$59,156	$23,409

3. A very low percentage convert or retain the policy on termination of employment. Again, some excerpts:

CONVERSION RATES (EXCLUDING AUTOMATIC CONVERSIONS)

Issue Age	Year				
	1	2	3	4	5
Under 20	5.6%	5.4%	4.6%	7.6%	0.0%
20–29	2.8	4.0	6.3	7.3	6.7
30–39	2.5	4.6	4.1	5.7	2.3
40–49	2.6	3.6	4.8	6.6	4.0
50–59	2.3	3.2	3.5	6.6	5.1
60 and over	2.8	3.2	5.2	8.8	3.0
All ages	2.6%	3.8%	4.6%	6.7%	4.2%

4. Group ordinary also results in small average-size policies and administrative problems which have been well documented.

A number of companies have designed individual section 79 policies to be written primarily for principals and key employees. In this situation, high-amount, low-lapse business should result, and a number of companies which would not write group ordinary for all employees could conclude that this would be a satisfactory product. Since a fair amount of this business would be generated on employers with less than ten employees, section 79 requirements with respect to such employers must be carefully followed. The amount of insurance in each coverage bracket may not exceed two-and-one-half times the amount in the next lower bracket, and the amount in the lowest bracket has to be at least 10 per cent of the amount in the highest bracket. Medical examinations may not be used to determine eligibility. Some companies are using multiple-employer trusts for these individual policies. The objectives seem to be avoidance of state limits on maximum amounts, ease of policy filing, and restriction of the permanent insurance to principals and/or key employees.

MR. PROVENCHER: In its traditional form, group term insurance generally fails to relate amounts of insurance to the needs of the insured. Indeed, a typical schedule relates amounts to earnings, to occupation, to years of service, and so on, and will tend to provide lower amounts at younger ages. Survivor income solves this shortcoming. Instead of offering a flat amount payable at death, it provides the survivors of the deceased employee with a monthly income, generally expressed as a percentage of

the employee's salary at time of death. Because the focus is on monthly income rather than on a lump sum, the typical buyer often finds it difficult to appreciate the insurance volume produced by survivor income.

The survivor income package is much more sophisticated than traditional forms of term insurance. There are several decisions that an employer has to make in terms of plan design and even funding vehicle.

Which is the first step to consider—the benefit level, or the determination of need? How far does an employer want to go? Next, there is the problem of integration with social security or the Canada/Quebec Pension Plan. Should it be on a direct offset or a formula basis? Next, should the benefit be funded through the pension plan, or through a term insurance plan? Should the benefits be indexed? How about possible conflicts with those jurisdictions allowing the employee to name his beneficiary while the surviving spouse is the automatic beneficiary under survivor income benefits? What medium can be used to attract high participation at younger ages when the cost of the plan is heavily borne by the employee? These are a few problems that a typical buyer must face.

The best market for survivor income benefits appears to be the larger employer who has established a "tailor-made" rather than a "ready-to-wear" benefit philosophy, and has set objectives in terms of replacing income and meeting the insurance needs. Examples are financial institutions such as banks and trust companies, the salaried employees of large corporations, and larger groups of white-collar type of employees. A survivor income benefit program is likely to mean less insurance coverage as a percentage of salary for older employees—these are usually the executives who make the decision to get or not to get a survivor income benefit. Some "grandfather" arrangements can help.

A survivor income program funded entirely through insurance which would best satisfy this market would include a spouse benefit of the order of 25–40 per cent of the employee's income prior to death. Cost considerations will generally preclude the introduction of a larger plan which would completely meet the needs of a surviving spouse. This benefit would be reduced by the amount of benefits arising from the OASDHI program or the Canada/Quebec Pension Plan. The integration can also be made by use of a "bent" formula, such as 15 per cent benefit up to the social security level and 40 per cent above. Generally, the appropriate social security or Canada/Quebec Pension Plan amount will be frozen at its initial level at time of death. The benefit will be payable as long as the spouse lives, with an additional clause of a five- to ten-year guarantee, or until remarriage. The benefit can also contain a minimum, such as a flat-dollar

amount, or a percentage, such as 10 per cent, of the employee's earnings prior to death.

A typical survivor income program would also include a children's benefit, such as 10 per cent (20 per cent for orphans) of the employee's earnings prior to death for the first two children, with appropriate reduction for the benefits payable under social security.

In the area of actuarial assumptions, the spouse benefit is generally calculated using the G*a*-1951 Mortality Table with a projection, with a female spouse assumed to be three years younger than her husband. For children the mortality is a minor element. Therefore, it is general practice to use certain annuity values adjusted for the probability of school attendance if the benefit goes beyond age 18.

The interest assumptions will reflect the company's investment performance. Generally speaking, a new-money rate net of expenses and taxes will be used.

The provision that the benefits will cease at remarriage is normally included. In such a case, remarriage discounts are used. These are based on the United States Employee Compensation System table or some adjustment to the Canadian Pension Act experience. Remarriage discounts are usually applied to female survivors only.

The effect of these discounts is to reduce substantially the equivalent insurance value of the survivor income benefits at the lower ages. Typically, a remarriage provision might reduce the total equivalent insurance value from 10 to 15 per cent, with a corresponding reduction in premium of from 6 to 8 per cent. The premium does not differ significantly. At the last annual meeting of the Canadian Pension Conference someone suggested that insurance companies were wrong to push for remarriage discounts because past experience in this area is not indicative of the future trends, especially when one considers current social attitudes. The use of remarriage discounts requires that the status of the surviving spouse be redetermined periodically to see whether the nonremarriage status is continued.

Survivor income benefits will generally have tax implications for the employees. The main tax implication is the imputed income arising from employer contributions for amounts of group life insurance in excess of a certain amount. In the United States the employee must pay tax on the value of group term life insurance in excess of $50,000 attributable to employer contributions. However, each dollar an employee contributes serves to cancel out one dollar of includable value attributable to employer contributions. In Canada a similar provision exists, except that

the income that is deemed taxable to the employee is based on the net employer contribution for amounts of group term life insurance in excess of $25,000. Whereas in the United States this value of employer contribution is based on rates (determined by the IRS) which vary by age, in Canada it is based on an average cost, determined for the whole group, which does not vary by age. This does not help to alleviate the problem of lack of participation at the younger ages.

MR. JOHN C. ANTLIFF: There is a question as to whether or how survivor income benefits are being incorporated into the conversion privilege under group term life policies. My company provides the right to convert the commuted value of the survivor benefit and uses the actual ages of the spouse and youngest child for this purpose, whereas assumed ages are used for premium and other purposes.

My company offers an alternative survivor income benefit plan which is deferred one or two years after the death of the employee. It is written with a basic plan providing group term insurance equal to one, two or three years' earnings. The purpose is to reduce the cost of survivor benefits and reinforce the concept that these benefits are fitted closely to the insurance needs of the participants.

Several companies offer a dowry feature with survivor income benefits. In my company, the dowry benefit is 20 times the monthly spouse benefit, payable upon remarriage of the surviving spouse. The purpose is to eliminate the disincentive to report a remarriage to the insurance company.

CORPORATE FINANCIAL MANAGEMENT OF MUTUAL LIFE INSURANCE COMPANIES

1. Considerations and recommendations for appropriate financial reporting of mutual companies.
2. Application and suitability of GAAP.
3. Concept and level of surplus and its distribution.
4. Entrepreneurism and policyowner equity.
5. Financial planning in a mutual company.
6. Role of financial officers.
7. Role and professional responsibility of the actuary.
8. Possible future changes or trends and their implications.

Dallas Regional Meeting

CHAIRMAN ARDIAN C. GILL: There are a number of audiences for financial statements: management, regulators, policyholders, and the accounting fraternity. In this discussion we are going to concentrate on management, commencing with a consideration of appropriate financial reports for identifying "good" results for your management.

MR. JOHN H. BIGGS: As part of the development of our advanced strategic planning system at my company, General American, we have established a "chart room" where we maintain a number of large graphs setting out the key financial items that we think our management should watch. Obviously the items included line up very much with our corporate goals; but the formation of the goals themselves has been a subject of considerable effort. Some specific items we have settled on for our goals, and hence charts, include the following:

1. Identification of growth goals of the company's total assets and total income. We have a chart setting out each major line's contribution to assets and income.
2. Surplus level objectives that must go with the growth objectives in item 1. Although this may be more a constraint than an objective, it is certainly an essential part of "good" financial results. We chart surplus levels for the company and for each major line of business.
3. Investment results. We chart our relative position on rate of return separately for mortgages, bonds, stocks, and our total portfolio among a "universe" of the fifty largest life companies. Because of our relatively rapid recent growth and the obvious correlation between high recent cash flow and good returns, we think that being in the top quartile on each of these

charts represents a good result for us. We do not attempt to define an absolute rate of return.

4. Sales results. We focus our charts on new premiums as opposed to any other measure such as volume, new lives, and so on. We are quite concerned about the mix of premiums among life, health, and pensions. Also, we chart carefully our sources of business, that is, the number of full-time agents making at least $10,000 a year in first-year commissions and the number of group representatives bringing in at least $200,000 of premiums. Finally, we chart our markets in the form of average premium per sale for our individual line as compared with the industry and the absolute number of group cases in force between 100 and 1,000 lives.
5. Level of settlement option reserves. We would like to see some growth but, unfortunately, have seen very little in the last decade. Reserves, rather than proceeds applied or benefits paid, are the best measure of this item.

Some results which are viewed conventionally as good and "chartable" which we do *not* follow on a total company basis are individual insurance persistency, which does not represent a long-range goal except insofar as it affects total income, and expense ratios, since we felt that these should be part of the over-all surplus goal. We do not chart in our long-range planning measures volume of insurance, number of lives, number of certificates, or investment mix.

The process of selecting the advanced planning emphases of a company is a matter of individual company determination. There is no one correct set of emphases applicable to our industry, since we have many different and legitimate company objectives.

CHAIRMAN GILL: John, are there any other long-range goals that you look at in your planning process?

MR. BIGGS: The task of defining what company management wants the company to be in a few years is a lot more difficult than one would think at first blush. For those who have not been involved in such an effort, I recommend reading the Corporate Planning Case Study which is included in the Life Office Management Association (LOMA) *Financial Planning and Control Report No. 17.* Incidentally, IBM made this case study into a movie, which is available from LOMA. There is some discussion in this report about how a company arrives at its "key objective." For the case study mutual company, the objective that evolved was to maximize the long-range increase in gain from operations. The report illustrates very well the difficulty and the vagueness in defining such an objective, and I was disappointed that the key objective ended up being that of a typical stock company.

The appropriate key objective for a mutual enterprise is some state-

ment of growth with provision for an adequate surplus (and its annual increment) to assure the commitments of the enterprise.

With the focus on finding the appropriate growth goal, we have a vast number of possible choices, including insurance in force, number of policyholders served, assets, number of repeat sales, premiums, and even key ratios such as the return on investments, expense rates, unit costs, and others.

We settled on a five-year goal triad in my company, which involves two growth objectives along with a surplus constraint. The triad consisted of reaching, over a period of years, $1 billion in assets, $500 million in total income, and $100 million in total surplus—with each of these measures comprehensively defined. In our case this represented growth rates in excess of 10 per cent for assets and 8 per cent for income and surplus. The surplus goal, of course, had to be analyzed carefully in terms of the many elements influencing surplus needs.

We have lived with this goal statement for several years, have built a financial model around it, and find it a satisfactory guiding statement for our financial planning.

MR. FRANK S. IRISH: In our company the establishment of financial goals has come about in recent years as a result of an increased planning effort aimed at exploring the basic issues facing the company. In particular, the establishment of interdepartmental task forces to study specific sets of problems has led to the creation of a variety of numerical goals for particular operating variables, such as lapse rate, sales manpower, home office personnel, return on new investments, budget ratios, the proportion of assets that will be in common stocks, and the like. The goal may be stated in terms of a rate of change from a base year or in terms of the relationship to industry averages, but in each case the goal must be appropriate to the issue being studied. The task force approach has been found to be most useful in establishing these goals. By drawing on the expertise of several departments, a group can be put together which is best qualified to evaluate the feasibility of a goal and its consistency with other goals (which must all fit together as a part of an over-all plan) and, in addition, to reflect an underlying sense of the general corporate direction.

The task force approach is essentially a "bottom-up" approach, which, by studying specific issues, can arrive at financial goals that can be put together into an over-all corporate plan. More recently, we have also put some effort into a "top-down" approach, which starts with the corporate objectives and works downward to the various financial goals. I will make the semantic distinction, if I may, between objectives and goals, in that

goals are specific numerical targets (which have been checked for feasibility), whereas objectives are broad statements of the general desires of management as to corporate direction and emphasis. We have designated the three basic corporate objectives as financial soundness, net cost to policyholders, and growth. We are now in the process of defining the quantitative implications of each of the objectives for operating policy and are beginning to see the effect of the objectives on the establishment of financial goals. Thus the top-down approach operates to introduce an element of more dependable consistency into the goal-setting process, but it is a difficult approach to carry out. Goals cannot be set without a detailed knowledge of particular areas of the operation, and, thus, I think both approaches are necessary.

CHAIRMAN GILL: Both of you mentioned growth goals. Do you have a specific number that would define your growth goals, or are you still working on that?

MR. IRISH: Some years ago my company had an excessive emphasis, in the ordinary lines at least, on sales volume. As time went by, we translated this into an emphasis on first-year premium, which is a more appropriate measure. The next step was to separate effects of productivity improvement from sales manpower increases. We established a standard for per-man productivity growth which was 5 per cent a year. Sales manpower planning was based on a very specific set of expense goals in the field. These are established in terms of an expense ratio for which the numerator is field expenses and the denominator is a weighted average of first-year and renewal premium—for example, nine times first-year premiums plus one times renewal premium. This expense ratio has the effect of forcing a decision and a plan on amount of manpower.

We have also been working on a top-down approach, and we see that first-year premium income is not really the goal. Total premium income comes closer to measuring what the company is trying to do in the long run. The trouble with total premium income as a goal is that it does not change rapidly in response to current decisions—first-year items are much more sensitive. We established the top ten mutual companies as our standard in the individual lines. Their premium income had been growing at a rate of 4.5 per cent over the last ten years and had not varied very much from that level. Our company had been matching the 4.5 per cent, but we slipped a little in the last couple of years. We are going to put together a set of plans that will bring that growth back up to the 4.5 per cent level.

CHAIRMAN GILL: How do you monitor progress toward these goals?

MR. IRISH: One approach to monitoring progress is an annual cycle in which, shortly after year end, results are reviewed and comparisons are made with previous projections. We have such a cycle planned to last from November through May. In the early part of the cycle top management receives and reviews reports from departments about long-range strategy formulation. Then, in February, after the year end, a detailed review is made of the previous year's results in each major product line and in various special functions such as budgeting, investments, and personnel, and also in subsidiaries. Each of the reports brings management of a particular area of the company face to face with corporate management, and this type of departmental reporting has the advantage of encouraging the departments to initiate the concepts that will govern their own plans and goals, as well as providing the opportunity to discuss past results and why they differ from projections. A coordinative role is played by the corporate planning department, which summarizes the plans and prepares the company-wide projection based on the various reports received.

This cycle is very much oriented to calendar-year results and makes no provision for the monitoring of progress on a more detailed time scale within the year—which is something that is quite necessary. To fill this gap, we have created a chart room with forty or fifty charts which compare monthly results with projections for a number of areas of the company. In addition, we provide a six-page quarterly summary of results to the one hundred top officers of the company, and this group meets periodically to discuss the particular issues facing the company.

Management, and particularly the executive committee of the company, is receiving information that is better, more complete, and more timely than in the past, but the sheer volume of information is becoming a problem. The next steps are to emphasize to a greater degree monitoring and reporting on an exception or deviation basis and to improve our display and analysis of information that is available. "Management information systems" is about the most important element in planning and perhaps the least-well-understood part of the whole process of corporate financial management.

CHAIRMAN GILL: Frank, assuming that people do pay attention to these charts, what happens if one of the goals is missed? Do you have some sort of accountability or responsibility?

MR. IRISH: Missing a goal should not lead to pointing the finger at the executive who missed the goal, but the ability to plan and achieve goals should be a general element of executive compensation. A specific charge of achieving a goal should not be made the responsibility of a particular executive, because this can lead to game-playing. Goals should be realistic. The criterion for goals should be that they are good planning assumptions.

The LOMA *Financial Planning and Control Report No. 26*, which is the sequel to *No. 17* mentioned earlier, discusses what happens when a goal is missed. The basic point is that when a goal is missed you have an opportunity to analyze what went wrong and to provide for better planning in the future.

CHAIRMAN GILL: Growth goals have been mentioned, and my company also has a growth goal, but there is support for the view that a mutual company should not necessarily have a growth goal. I wonder whether anybody holds that point of view or would like to comment on what might be appropriate growth goals for a mutual life company. We set our goals in terms of the competition. We select twelve companies that resemble us and select the position in that array that we want to occupy, rather than aiming for an absolute amount.

MR. CHARLES GREELEY: We all know that growth is needed to help counteract the effect of inflation on expenses; but, aside from that, is growth absolutely necessary?

CHAIRMAN GILL: In analogy to Parkinson's law, even in the absence of inflation, expenses tend to increase at a predictable rate regardless of whether business increases. Another point of view is that, in a mutual company, to grow at all you are borrowing from the existing policyholders, and perhaps that is not in their interests. One thing that could help in that respect is a shift toward generally accepted accounting principles (GAAP) accounting, or some modification of it, as, for example, use of the Commissioners Reserve Valuation Method. Have you taken any steps toward GAAP, Bob?

MR. ROBERT HOUSER: We have done nothing in the way of GAAP accounting for published annual reports, although we do have a good proportion of CRVM reserves and have had for some period of time. However, if one looks at GAAP accounting as a way to analyze one's own results for internal management purposes, then we have done something like this for several years, in that we have made an all-out effort to calculate what we call realistic reserves. Others may call these gross premium

valuation reserves, dividend funds, or asset shares. We have attempted to arrive at our best evaluation of realistic reserves for each line of business—group pensions, group life and health, individual life, and individual life, and individual health.

We feel that calculation of realistic reserves is essential if we are going to do any kind of financial management in terms of surplus goals. The annual statement type of surplus is pretty meaningless for such purposes. We calculate these realistic reserves as soon as possible after the end of the year. This type of realistic reserve analysis is an absolute necessity if we are ever going to know what kind of progress we are making toward surplus goals. The resulting realistic surplus figures are not made public and do not go outside the company.

CHAIRMAN GILL: Do you have surplus goals for each line of business?

MR. HOUSER: We set separate surplus goals for each of our four major lines of business. In trying to come up with these realistic surplus goals, we could find no clearly defined answer as to how much surplus we really needed. One approach would be to look around at other companies which are major competitors and then pick a surplus goal somewhere in the middle. But how much surplus does a mutual company really need? If you look back in the history of mutual life insurance companies, you will see that seldom has surplus ever gone down. With this background, you can take the line of thought that you do not need any surplus.

It should be pointed out that surplus serves several functions. Surplus not only helps protect the financial solvency of the company, that is, helps guarantee that you will be able to live up to your promises, but also gives you the freedom to move into new lines of business that are going to require some front-end capitalization. Surplus also has a public relations value. Another value of surplus is that the net-after-tax interest which it earns can help you in your future pricing. A company in a comfortable surplus position has more freedom of action in pricing and in its financial management than a company with low surplus.

We concluded that there was no way we could set a single company surplus objective. Our company surplus goal is just the sum total of the surplus goals by line of business. Our company-wide realistic surplus ratio is declining, even though we are meeting our surplus goals for each line of business, because we have lower surplus goals on our group lines than we do on our individual lines and the group lines are growing faster than the individual lines.

One cannot set surplus objectives in a vacuum. They are very closely tied to growth objectives. When we set our surplus objectives, we also

set our growth objectives so that they would be compatible. One cannot opt for a high growth objective and a high surplus objective at the same time. They operate in different directions.

CHAIRMAN GILL: Your remarks on the eroding of surplus by new business, Bob, prompt me to ask this question. If surplus is going down because you are writing a large amount of new business, how do you communicate to your management that your surplus objectives are still reasonable, and how do you get management to understand that?

MR. HOUSER: We have had actuarial representation at a high level in our company for a long time. Management includes more than the president or chairman. It also includes the heads of the various operating departments, and it includes sales people. Our management team examined these surplus and growth goals thoroughly and at some length. By the time we were through, we all had a much better understanding of the way things work and the fact that growth objectives and surplus objectives are very closely interrelated. As a result, in one of our major lines we concluded that we had to curtail our growth objectives. It takes a real appreciation of the surplus problem to persuade the head of an operating department to agree to curb that department's rate of growth in order to achieve surplus objectives. One further comment: although I have been talking about realistic surplus, not statement surplus, you still cannot completely ignore statement surplus. For practical reasons, you have to maintain a reasonable level of statement surplus.

CHAIRMAN GILL: These remarks prompt me to ask Frank a question on surplus. Many companies have experienced declining surplus ratios recently, and, Frank, yours is one of them. Is this a cause for concern in your company?

MR. IRISH: Yes, and it is a cause for concern in other companies, too. The recent decline in surplus ratios in mutual companies has been quite dramatic. The average surplus ratio for the ten largest mutual companies stood at 6.54 per cent in 1968 and had varied little for quite a period of years. Since 1968 the average for these ten companies began to drop at about 0.25 per cent per year and was 5.21 per cent at the end of 1973. However, this pervasive and almost universal decline in surplus ratios among the largest mutual companies should not be viewed as something that just happened. The decline has, to a large extent, been anticipated and planned for in the various companies. In my opinion, what happened in many companies was that the pressures of competition and growth

caused management to question long-held ideas about the need for holding a comfortably high surplus. In most cases, it was decided that not quite so much was needed. I can think of three factors which make today somewhat different from ten to twenty years ago, but I do not think this is a complete explanation. One of these factors is the rapid growth of group pension business which has already been mentioned by Bob. This business has a lesser need for high surplus ratios because of the relatively lower risk assumed by the insurance company upon many modern forms of group pension contracts. In the ordinary lines, however, our ratios are also dropping and this is often ascribed to a somewhat general profit squeeze. There is another factor, and that is a declining concern about the soundness of reserves, a matter which was of some importance ten or twenty years ago. I am not saying that reserves have necessarily become redundant, but I do think management feels that today reserves and premiums have been put on a basis such that there is plenty of opportunity to meet most conceivable deteriorations in experience by varying dividends and operating policy. A third factor that I see is the federal income tax, which tends to give some incentive to have a lower surplus ratio by taxing the investment income on surplus at full corporate rates.

CHAIRMAN GILL: Do you think that surplus ratios will continue to go down?

MR. IRISH: Yes. I think these factors will continue to operate in most companies and will continue to drive surplus ratios down. It is difficult for me to try to forecast exactly where surplus ratios will tend to reach bottom and stabilize, but I feel quite sure that within a few years the average surplus ratio of large mutual companies will be below 5 per cent. There is another factor. This is the consumerism aspect. There is going to be a growing concern on the part of the public about what I would call a "real or imagined redundancy" in reserves. This, of course, relates back to the GAAP question as well as to many other things. The public concern about the kind of safety margins that mutual companies tend to hold is going to be another factor which will put pressure on surplus ratios and will tend to drive them down over a period of time.

CHAIRMAN GILL: John has a corporate goal to increase surplus, and you are predicting that surplus ratios will be going down. Do you have a surplus goal at the moment?

MR. IRISH: We just went through a major exercise of trying to define proper levels of surplus. First, each major product area defined its surplus

needs. The needs of group pension were defined at quite a low level. Group insurance defined its needs not in terms of surplus ratio at all but in some kind of relationship between surplus and premium income or defined risk in the group insurance lines. These were not goals, however; they were minimum levels below which the various lines felt they should not go. Adding them all up gave a figure for the company which was quite low, and definitely a figure below which the company did not want to go. What we ended up with was reaffirming the responsibility of corporate management for the surplus ratio, saying essentially that, in every case of a change in policy or adoption of a new program or project, a very careful look at the surplus ratio was required along with the application for change of company policy. Thus corporate management would continue to monitor surplus and be responsible for it. In addition, we are not forgetting about comparison with what other companies are doing, since one cannot get too far outside that range either. So we really do not have a goal, but we have defined much better the process of how we decide what we do from year to year.

CHAIRMAN GILL: My company has shared in the decline in surplus ratios, although not to the same extent. Our surplus ratio is leveling out now at about 8 per cent, but we do not pay a great deal of attention to that. What we look at is what I call total surplus, which is surplus on a statutory basis plus the mandatory securities valuation reserve. I prefer that the ratio be taken to assets because the MSVR is an asset fluctuation reserve. If that is done for all the companies, one will find that, except for this last year, with the impact on the common stock component of the stock market, the decline in surplus ratio has been much less dramatic.

MR. GREELEY: Is there a difference in surplus goals by line of business?

MR. HOUSER: Yes, a substantial difference. The thing that bothers me in regard to all of these comments about the surplus ratio is that I think they mostly refer to statement surplus, which I feel is rather meaningless, rather than to realistic surplus. We have dropped the idea of paying much attention to statement surplus in our analysis of financial results.

MR. GREELEY: Does your management receive detailed financial reports of realistic surplus? Also, do you analyze each year's changes?

MR. HOUSER: Yes, to both questions. One of our regular yearly problems is not only to determine whether we have met our realistic surplus goals for the year but also to analyze the source of our realistic surplus

margins. We are very much interested in knowing each year why our surplus results came out the way they did. Was it something that had some real significance, or was it only a chance fluctuation? When you try to break down the source of your realistic gains, you face some real problems. That is the area in which we are currently doing quite a bit of work.

MR. HARLOW B. STALEY: Is all your surplus allocated to individual lines of business?

MR. HOUSER: Yes. Realistic reserves are, of course, calculated differently for the various lines of insurance. For calculating realistic reserves on individual life insurance, we treat dividends as a future benefit. One could consider these reserves as gross premium valuation reserves based on the same mortality, interest, expense, and persistency factors as are used in our current dividend formula. This obviously means that our realistic reserves are negative during the first few policy years. We treat them as negative rather than zero in calculating our realistic surplus.

CHAIRMAN GILL: Realistic GAAP-type surplus would typically result in an increase in surplus and perhaps an increase in the contribution to surplus. This may put pressure on dividend factors and put pressure on the actuary to distribute more in dividends. John, do you think that this is going to be a problem, and how will we cope with it?

MR. BIGGS: I think that for mutual companies this will be the central question in analyzing the proposals for GAAP and in deciding on their implementation. It would seem to me very likely that companies will modify their basic dividend practices and policies to accord with their GAAP decisions. I think that in addition to dividends, however, there will be real problems for actuaries in the pressures to relax expense controls and limitations. An article in the *Wall Street Journal* last summer quoted an officer of a large stock company as saying that under GAAP we had the best of everything: higher commissions, more sales, and, at the same time, higher earnings.

I wonder, however, whether the problem is a new one to us. Although the difference between statutory and GAAP accounting may be greater, the difference between a net level and a preliminary term reserve basis is parallel to it. Presumably the companies using preliminary term have dividend scales relating to the reduced reserve basis, and the problem of first-year surplus drains is lessened. One could argue that the change to GAAP is only a matter of degree.

The basic management problem confronting actuaries and others in company management is that of defining appropriate expense and dividend levels for their companies, without relying on an extremely conservative net level reserve basis that gives undue support to the side of caution and conservatism. If agents' balances become admitted assets, will we be able to define a limit for our agency divisions' lending? If commissions can be capitalized, will there be any limit on first-year payments other than what regulators will impose? If the current cost of electronic data processing programs can be written off over the years, can we define a restraint for current-year expenditures? And, finally, if we can capitalize the training cost of new actuaries, is there any limit to the demand for new students?

In short, the application of GAAP, and to a partial extent the use of CRVM, force the management of mutual insurance companies back to some very basic financial and business judgments.

MR. THOMAS F. EASON: Is it desirable for the chief actuary, or perhaps more than one actuary, to be on the board of directors of his company? There are some consultants who refuse to serve on a client's board. The question has two aspects. First, is there a foreseeable professional conflict resulting from an in-house actuary's being on his employer's board? Second, is board membership helpful, or perhaps necessary, to explain and shape company goals?

CHAIRMAN GILL: Jack Moorhead has taken a position that there should be no employee trustees in a mutual company; perhaps it is permissible in a stock company. I say that it improves communication and that, as long as such persons are distinctly in the minority, it is helpful to have someone knowledgeable from the company who is on the board. It may as well be the actuary as anyone else.

MR. HOUSER: We have several actuaries currently on our board. I do not really see why there is any difference between an actuary on the board and any other in-house employee on the board. I have difficulty in seeing that actuaries have any more conflict of interest in this situation than anyone else. I do not see anything wrong with a few inside people. In fact, I would find it difficult to conceive of an effective board that had zero inside representation. My philosophy would be that inside people would be in the minority on the board, but that minority could be made up of either actuaries or nonactuaries.

MR. MARTIN L. ZEFFERT: We are a small company, and only our president is on the board. Many of our senior officers sit through many of our board meetings—as a resource for our president. If there is hope for an effective mutual company board, I do not see how that hope is going to be enhanced by in-house representation on the board, since the in-house representation merely gives the president that many more votes.

CHAIRMAN GILL: Tom Eason has touched on the interrelationship of disciplines. John Biggs is an actuary, and he is also the controller of his company. Do you think being an actuary has helped you, John, in the management of financial matters in your company?

MR. BIGGS: I think that the actuary as controller does have a great deal to offer in terms of the interrelationship between surplus distribution and planning and other interdisciplinary relationships. However, to keep things in perspective for our profession, I think I should say that the actuary has much to learn about subjects not broadly covered in the syllabus before he becomes an effective controller. Financial management of assets as well as liabilities is one such subject. Another is the subject of expense control and general financial control as well as analysis of expenses.

The actuary does, however, bring to the controller's job a number of assets. These include an understanding of the mysteries of the reserving processes; the ability to interpret effects of asset shares or experience funds on financial statements, the surplus distribution system, and surplus needs; and the ability to bring some creditability to the assessment of proper levels for expenses.

The last point is one in which our companies need as much understanding and enlightenment as possible. A typical pattern for all of us is to spend many man-months of very conscientious tabulation of budgets of each of our many departments. Finally, when the total result is assembled, judgments must be made as to the overall wisdom of the resulting expense level. Hopefully, some individual in the company can relate the proposed budget expenditures to the planned results, in order to be sure that if the company meets its plan and budget it will then achieve a desired result.

I might mention another area, which I would call the entrepreneur-actuary schism, that the actuary/controller can help to bridge. I would illustrate this schism by two conflicting propositions. The first proposition is that successful long-range planning is a strategic function of top management. It is not a mere exercise of numbers performed by the financial technicians alone. That is, the actuary cannot do it by himself.

The second proposition, widely held not only by actuaries by by others, is that the actuary should have virtually undisputed authority over the basic dividend distribution of the company, both as to how much and to whom. The actuary is an "independent" professional. It is dangerous and unsound for the entrepreneur in the company to question the actuary's judgment about dividends, about required reserves, or other financial judgments.

The result of the above two positions can be an unenlightening controversy between the entrepreneur elements in the company and the actuary, with the upshot an excessively cautious approach to strategic planning or—the alternative—domination of the actuary by others. I think that a third-party controller, who is also an actuary, can serve to bridge this difference, making sure that legitimate probing by the president of the company does occur while at the same time arguing for respect for the legitimate professional concerns of the actuary.

MR. DONALD M. PETERSON: When a company actuary is a board member, there can be more meaningful discussion as the board endeavors to determine the company's objectives and plans. The outside directors of a mutual company are generally outstanding business and professional people, but they may not fully understand just what is going on in the insurance business today to the extent that the inside people do. To have a board made up entirely of outside people, with the exception of the chief executive officer, could be to have a board lacking vital knowledge as to just how well the company is doing currently and what its future goals should be.

I do not think that the presence of the company actuary on a mutual company's board of directors creates a conflict of interest. Whether one is a company actuary or a consulting actuary, his first obligation most likely is to himself and his family. So even a consulting actuary's first obligation is not necessarily to his client. For that matter, it seems that the actuary's second obligation is to his employer, the source of his paycheck, whether consulting firm or insurance company. His obligation to his client may well rank third. If one is a member of the board of directors of a mutual company, his company's policyholders are his employer as well as his client. In this instance, perhaps there is even less of a conflict of interest than with a so-called independent actuary retained by management.

CHAIRMAN GILL: Thank you, Mr. Peterson. I believe that Ed Lew summed up the order of priorities beautifully yesterday in talking with

the new Fellows at luncheon. He said: "If you have a choice, make the choice that lets you sleep better instead of the one that lets you eat better."

We were touching on the entrepreneurial interest, and John just mentioned that of the mutual policyholder. This causes me to wonder whether there is some conflict in a mutual company diversifying into other fields —nonlife insurance, for example. Frank, your company is now in the property casualty business. What is your opinion?

MR. IRISH: Any such action must be consistent with the objectives of the company. This means that, in the long run, such a venture ultimately must be of benefit to the policyholders. Often, ventures of this type are justified by the increased efficiency of the sales force that may result. An increased variety of products, but all related to the same basic goal of financial security, gives the agent an opportunity to do more selling in the same amount of time. This argument has an undeniable logic to it, but the analysis of the value of any particular venture in this regard is still difficult to carry out.

I think that corporate management should never accept this kind of reasoning as sole justification for any such venture and should always demand that the venture be seen as ultimately profitable. Profitability in itself is an extremely difficult factor to analyze because, typically, ventures of this nature involve high initial outlays which must be recouped from later operations, and it is very difficult at the outset to know exactly what kind of operation you will have once the initial growth period is over. This certainly applies both to a new casualty venture and to a new mutual fund venture. It is extremely difficult to project financial results. But your management must be convinced that ultimately these results will be beneficial for the policyholders.

There is no basic philosophical difference in my mind between this kind of reasoning on a nonlife venture and on any project of expansion or a new way of doing things within the life field. The same kind of reasoning applies to the establishment of a new agency, the adoption of a new computer system, and many other projects that we have considered normal and natural for a number of years. In all cases they can be very difficult to evaluate for profitability, but the only possible justification for them is that they would ultimately be profitable to the policyholders.

CHAIRMAN GILL: I think that the environment may have changed a little. Now we are talking about declining surpluses and also, simultaneously, about new ventures that have a much larger initial outlay

and a longer payout than does the introduction of a new product line. I think there is a limit to how much surplus you ought to commit to new ventures in order to avoid impairing your dividend distribution to your current policyholders.

MR. HOUSER: I do not have any philosophical problems in going into the casualty insurance line. I would agree that it should have a reasonable expectation of being self-supporting over the long haul and of being able to pay back the portion of surplus that was borrowed to start it up. I think that a more fundamental problem is posed for the mutual company which forms a downstream stock company to enter the casualty business and then finds that this business is highly profitable. In that situation you have a mutual company owning a stock company that is making substantial profits. What do you do with these profits? Do you give them back as extra dividends to the mutual policyowners in the life company, or do you cut the cost in some way for policyowners of the stock casualty company?

My feeling would be that, if such a situation developed, we would tend to treat the policyowners of the casualty company pretty much like mutual policyowners. I think they would be entitled to whatever rate break we felt we could legitimately give them.

A somewhat different question is posed when and if you enter some noninsurance line, such as, for example, selling EDP services. What do you do with profits in that situation? I say that, if you can make a dollar, you should go ahead and keep it. Does anyone here have any different philosophy on that?

CHAIRMAN GILL: I do. We believe that the mutual policyholders are the investors and are entitled to the return on their investment. When we enter a line like individual health, we are just forming another pool of participating policyholders. In diversification ventures, however, and, in particular, through the downstream holding company route, we will try to retain all the profits for the investors, who are the policyholders.

MR. HOUSER: I do not see any difference between going into a health line and going into an automobile insurance line when both involve borrowing surplus which has been built up by the life policyowners. What is the fundamental difference?

MR. IRISH: One of the fundamental differences is that you do not give yourself a two-way street when you go into a nonparticipating nonlife line. You are trying to price the product on a nonparticipating basis in a

competitive market, and this means that your mutual policyholders back in the parent company are taking a risk. If you go into a participating line, you presumably have the freedom to set your rates high enough so that you have considerably more margin to operate.

CHAIRMAN GILL: Is the current profit orientation a fad or a long-term trend?

MR. BIGGS: This is an especially interesting question as it applies to mutual life insurance companies. The trend is manifested, as I see it, in more efforts toward diversification and in greater interest in growth in general. Perhaps the results of the next three or four years will be very critical in determining whether the new orientation is long term or a fad.

My company has embarked on several ancillary services ventures that typify the present orientation. We are optimistic that our efforts will be successful, but I think that if they are not, there will be a real reluctance to continue such a diversification program. The benefits do not appear to be necessary for a company's survival or perhaps even success.

If some companies do have significant successes, we should see a widening in the cost differences of life insurance. Also, there may be an interesting differential between stock and mutual companies, in that the stock companies approach diversification at the holding company level with the venture seen basically as one of the stockholders, with any returns, good or bad, going back to the stockholders. In the case of mutuals, of course, the diversification results are all reflected back to the policyholders and thereby affect product cost.

I would expect that some companies will do a good job with their new ventures and make a modest but useful contribution to lower policyholder net cost. And, perhaps more significantly, they will make a substantial contribution to the vitality of their organizations by increasing over-all productivity in our usual activities.

Montreal Regional Meeting

MR. HENRY B. RAMSEY, JR.: The question of whether a better form of financial statement can or should be devised for mutual life insurance companies is one which has been of interest for some years but has received increasing attention recently in the form of activities which have a bearing on it. The work by the Committee on Financial Reporting Principles of the American Academy of Actuaries to develop Interpretations and Recommendations with regard to the proper accounting treatment for participating life insurance of stock life insurance companies

has raised the basic question of the proper form of accounting for participating life insurance, which is, of course, the cornerstone of the mutual life insurance company's business. The audit guide for stock life insurance companies, released over a year ago, specified that the principles contained in the guide were developed only for stock life insurance companies but clearly raised the question as to whether there should not be a prescribed set of principles applied to mutual life insurance companies. In recent months the American Institute of Certified Public Accountants has formed a small committee to consider whether some steps should be taken toward prescribing a different form of financial statement for mutual life insurance companies, and the Academy has formed a counterpart in the form of a subcommittee to its Committee on Financial Reporting Principles to work with the AICPA committee. The Securities and Exchange Commission clearly exempted mutual life insurance companies from its accounting rules related to filing of financial statements on a GAAP basis but implied that there would be further action with regard to mutual life insurance companies. The Canadian Life Insurance Association released last month a report of its Committee on Life Insurance Accounting, in which it accepts the proposition that there should be a set of generally accepted accounting principles for life insurance companies and agrees that a set of accounting principles should be developed that is applicable to both stock companies and mutual companies.

While no one of these steps necessarily helps to obtain a definition of an appropriate set of accounting principles for mutual life insurance companies, each one adds more pressure to define or determine what those principles should be. Therefore, we find ourselves today with very little agreement as to what GAAP really means for a mutual life insurance company, but with a great deal of pressure to furnish such a definition.

In recent years, while industry representatives were struggling to work with representatives of the AICPA in defining GAAP for life insurance companies, a great deal of attention was given to the establishment of such principles for participating business. The Subcommittee on Accounting for Participating Insurance of the American Life Insurance Association was assigned this task and proposed some basic principles which should apply to the accounting for such business. Agreement could not be reached with the AICPA on an approach, and it was agreed that the stock life insurance company accounting definition should be completed, with the accounting for participating business to be tackled later.

The income statement of a mutual life insurance company ideally should measure the true contribution to the company surplus. There has been relatively little agreement on what income means in a mutual life

insurance company. I would define the most useful net income figure for the management of a mutual life insurance company to be that figure which best relates to its ability to continue its present dividend scale. If that definition is accepted, then there is a pattern which could be developed for defining the various factors which enter into the income statement for a mutual life insurance company. The primary focus in the income statement will be related to the assumptions underlying the dividend scale. As Don Cody has illustrated in his paper "Adjusted Earnings for Mutual Life Insurance Companies" (*TSA*, XXIV, 31), the contribution form of dividend scale can be analyzed in such a way as to demonstrate that using the assumptions underlying the present dividend scale as experience assumptions will produce the statutory reserve as the proper policyholder reserve. There are some exceptions where the dividend-scale assumptions obviously are not intended to be conservative judgments of current experience but rather include some known and expected differences between the assumptions and the expected experience. Two of the most common differences are the graded expense charges in most dividend scales which are intended to recover acquisition expenses and the use of ultimate mortality rates instead of select mortality rates, again with the expectation that such mortality savings will assist in the recovery of acquisition expenses. A practical question arises as to the clarity with which such assumptions can be identified as being deliberate and measurable.

A more useful form of income statement could be prepared if such assumptions in the dividend scale could be identified and could be recognized in the valuation system, so that, if the company actually obtained the experience anticipated in designing the scale, net income would not be altered by that experience. Then the income statement would indeed measure the difference between the anticipated experience necessary to support the dividend scale and actual experience. That amount could then be judged as to whether it was an appropriate level of contribution to surplus. Further analysis obviously is required to determine the impact of fluctuations in experience on current-year results, and finally, intensive underlying analysis is always required to determine whether, and if so in what elements, the present dividend scale should be modified. Determination of dividend-scale assumptions is not solely a question of analysis of experience. For example, to say that net cost considerations do not enter into dividend-scale assumptions is to be unrealistic about the considerations which must be dealt with in establishing dividend distributions.

One area which clearly is troublesome to some mutual companies in the United States relates to the existing statutory requirement in many

states of a maximum 3½ per cent interest rate in connection with the valuation of single premium annuities. Here there is a severe strain at the time of issue of the contract, and, if the volume of business is of any substance, there will be a marked distortion in the income statement caused by the very high interest rates currently available on new investments and the reflection of those rates in the premiums that are being charged for single premium annuities. An adjustment which would present a more realistic income statement for company management would be to use a more realistic interest rate than the required statutory valuation rate.

What is the likelihood that some commonly accepted definition of GAAP will be presented for general adoption? It seems to me that this is unlikely to occur soon. The statutory form of statement essentially serves mutual company policyholders and regulatory bodies well. A more refined form of statement can be helpful to company management, but the formulation and adoption of a uniform set of definitions for this statement are some years off, because many companies are not motivated to invest funds in making this determination. The critical nature of the need for such adjustments by mutual companies is so vastly different from that for stock life insurance companies that I doubt that we will see very quickly a clear definition of GAAP for mutual life insurance companies. There are many difficult questions to be answered in defining a basis which would be satisfactory to the great majority of mutual life insurance companies. Thus, this is an area where each company may do some experimentation on its own and where ultimately some basis may be adopted industry-wide, but I believe that this is a long way off.

Recently I surveyed fifteen large United States mutual companies with regard to their use or planned use of a form of income statement other than the statutory form. While only three companies indicated that they definitely were now using or planning to use an alternative form of income statement, a majority of the fifteen expressed interest in such a statement or indicated that they are experimenting with developing a basis for such a statement. There is no overriding momentum on the part of the companies themselves toward development of an adjusted earnings statement for mutual life insurance companies, although for internal use there is considerable interest in improvements to income statements.

A good reference document for background on this subject is the paper prepared by Robert L. Posnak of Ernst & Ernst entitled "General-Purpose Financial Statements for Mutual Life Insurance Companies." Bob does an excellent job in summarizing the various considerations relating to accounting for mutual life insurance companies and proposes an approach which might be adopted.

MR. ALLAN K. ARCHER: I shall comment upon the concept and status of financial reporting in Canada and the implications of such reporting for mutual companies.

In speaking of status, first let me give a little background information. Review of, and activity toward change of, financial reporting for life insurance companies in Canada began with the Canadian Institute of Chartered Accountants (CICA) some time in 1969 and probably was prompted primarily by the activities of the accounting profession in the United States. At that time the CICA appointed a study group, and early in 1970 a committee was established by the Canadian Institute of Actuaries (CIA), to be followed later by one for the Canadian Life Insurance Association (CLIA). All were established for the purpose of reviewing and commenting upon the content and nature of the financial statements of life insurance companies in Canada.

I believe it is accurate to state that, in Canada, there was no severe pressure from investment analysts or requirements by the stock markets and securities regulatory authorities for change in financial reporting. Undoubtedly there were rumblings of dissatisfaction from several quarters as to the extent of disclosure in these financial reports and their seeming lack of uniformity, but there were no dictums or legislation or regulations necessitating change. At the same time, there were no particular problems resulting from a sudden rash of promotion of new life insurance companies. As for the insurance regulatory authorities in Canada, they have worked long and hard toward ensuring for the industry a high level of public confidence and toward achieving a solid image of stability and solvency for the industry.

The legislation and regulations under which life insurance companies operate in Canada offer considerable discretion and latitude to both authorities and those professionals within the industry charged with certification of the actuarial liabilities of the companies, namely, the actuaries. Reserve standards are not prescribed precisely by law in Canada but are set forth in regulations and are employed by each actuary as his professional judgment dictates. As long as the actuary uses a mortality table approved by the superintendent and an interest rate not exceeding a prescribed maximum, he is free to use reserve assumptions of his own choosing.

By reason of these significant differences between the Canadian and the United States scene, I believe it is fair to stress that all concerned in Canada were desirous of ensuring that any changes adopted would be appropriate to the Canadian situation and would not be direct importations of United States practices unless there was a direct parallel.

At the moment, all three organizations have published their reports on the subject. The accountants' report which has been out for over a year, draws a number of conclusions and makes a series of recommendations. It, however, is only a research study and at this point has no formal status with the CICA. Rather, the CICA has been awaiting the reports of the other two bodies. The CLIA report has been published, and the CIA report has been accepted by its Council and published for further discussion.

As one might expect, these reports are by no means unanimous. There is an underlying thread of consistency in them, but much yet remains to be done. The climate for further discussion and negotiation appears to be highly favorable.

The federal superintendent of insurance at the annual meeting of the CLIA last week offered to take the initiative if the efforts of his department were aided and supported by an advisory committee with representatives from the three bodies. This proposal was received very favorably by the CLIA. Recommendation was made subsequently to the executive committee, and there is reason to believe it will be acted upon. Yesterday at the CIA meeting it was reported that the Council is prepared to follow through and name representatives. I am not aware of the accountant's reaction, but hopefully they will agree with the merits of this course. We are fortunate indeed in having a strong federal department ready and willing to provide the catalyst in this very important matter.

On the subject of concept, I will confine my remarks to the concept of the CIA report. The committee deliberated during many sessions in an effort to bring forth a statement that would be viewed as representative of what the profession believes should be done with financial reporting in Canada. The approach is not one of response to the CICA research report but rather an outline or description of the nature and content of financial reporting as seen from the unique position of the actuarial profession. The committee has sought to express actuarial fundamentals, principles, and methods as they are applicable in Canada and has endeavored to find the best way in which these fundamentals and principles can be applied.

With respect to GAAP accounting for life insurance, the following is taken from the introduction to the CIA report: "The Committee is firm in its opinion that the life insurance industry is unique in a number of respects and that a set of accounting principles that may be entirely appropriate and suitable for other commercial enterprises generally, is not presently totally appropriate for application to the life insurance industry. For this reason the Committee position allows for a set of generally

accepted accounting principles for life insurance companies, which principles would not necessarily coincide in all instances with those for other industries."

The primary focus of the CIA report is upon the role of the actuary, the reserving system, acquisition expenses, and the development of a single set of financial statements.

In the matter of the role of the actuary, emphasis is laid upon the actuary's responsibility as the sole arbiter of the actuarial assumptions underlying the policy reserves, the required contingency reserves, the modifications to provide for deferral of acquisition costs, and any required adjustments to meet the minimum standards of regulatory authorities. Recommendation is made for change of the required actuarial certificate to one which incorporates an opinion paragraph and a certification paragraph. The opinion paragraph relates to proper and sufficient provision for all unmatured obligations through the policy reserves, to proper and fair statement of operating income for the year, and also to retained earnings. The certification paragraph is to the effect that minimum reserves standards specified by the applicable act have been complied with.

The committee asserts that the actuary has responsibility for considerably more than just the liabilities. While it recognizes the necessity for communication with the auditor in order that the auditor can make his checks and verifications, the actuary has sole responsibility for these matters.

The concept set forth by the committee with respect to the reserving system is one designed to keep to a minimum any drastic changes in reserve systems while at the same time making appropriate disclosure of unamortized acquisition costs without imposing upon any actuary particular methods and procedures.

The committee, in considering acquisition costs, was eventually unanimous in its conclusion that, given that deferred acquisition costs should be disclosed, such deferral and the subsequent amortization should be provided by the reserving system.

This led to a concept of policy reserves which are equal to the reserve for future policy obligations minus unamortized acquisition costs. The increase in these policy reserves is used in the statement of income when operating (or GAAP) income for the year is determined. Further provision toward solvency is provided by the addition of certain solvency safeguards which may be required by statute or regulation or may be deemed necessary by the actuary himself, by company management, or by regulatory authorities. These additions are viewed as charges to income in arriving at the net (or statutory) income.

While the final determination of the form of financial statements such

as the balance sheet, the statement of income, and the statement of retained earnings is the prerogative of company management in consultation with its auditors, the committee's concept is based on that of a single set of financial statements, and therefore, the committee included in its report some representative examples of such statements.

The CIA committee, like the CLIA committee and indeed the federal superintendent, recommends a single set of statements. Consequently, the representative statements show in the balance sheet on the asset side such items as furniture and equipment, amounts due from agents, and the like (known to us as nonadmitted assets) and then an appropriation of a like amount under retained earnings as one portion of the solvency safeguards. The policy reserves, which you will recall are the result of reducing the reserve for future obligations by unamortized acquisition costs, are shown on the right-hand side in the familiar position, and the amount of unamortized acquisition cost is disclosed in a footnote to the balance sheet.

The statement of income takes the familiar form of income less amounts paid out or set aside, including in the latter the increase in policy reserves. The difference between these two sections is termed the operating income; this, in a footnote, is reduced by the solvency safeguards I spoke of earlier, which additional amounts are not available for distribution. The statement of surplus or retained earnings is divided into appropriated and unappropriated, with further subdivision of the appropriated in order to disclose the solvency safeguards, the investment valuation reserve, and other items and, in the unappropriated section, the participating policyholders' portion and the shareholders' portion.

Other aspects of financial reporting are covered in the report, including a section on participating insurance, which, in Canada, is an important segment of the total business of both stock and mutual companies. Most mutual companies in Canada also have a sizable portion of their business in the nonparticipating fund.

Throughout the report, while seeking to achieve more disclosure through the financial statements, the committee has striven to preserve the degree of flexibility presently available to company management, regulatory authorities, and the actuary in preparing for completion of his certificate. The committee also has been mindful of the desirability and the need to avoid an upheaval or revolution in the area of financial reporting because of a change to concentration on uniformity and rigidity in presentation. I would add that the committee also has recognized the need for the codification of actuarial principles in Canada and has recommended to the Council that action be taken on this matter at an early date.

In connection with the implications of these changes for mutual companies in Canada, it is interesting and certainly significant to point out that all three bodies reviewing this subject have stated quite clearly that the principles for financial reporting should be the same for mutual and stock insurance companies. It is recognized that this reporting perhaps should be modified or interpreted in ways that result in realistic presentation of the operations under review. The reasons for this acceptance of consistency in reporting principles can be stated to be mainly for improved public acceptance.

In addition, the differences in Canada between mutual and stock companies are insufficient in the eyes of the public to warrant different accounting and reporting treatment. There is a blurring in Canada of the distinctions between mutual and stock companies by reason of the issuance of both participating and nonparticipating business by both types of companies. For example, for the five largest mutual life insurance companies in Canada, participating funds are 74 per cent of total (participating and nonparticipating) funds. For four large stock life insurance companies, participating funds are 65 per cent of total funds. On this basis there seems to be no clear-cut distinction between mutual and stock companies.

In summary, financial reporting in Canada can be said to have passed through the exploratory stage. It would appear that its basis, nature, and form now will be formulated within the industry, but with input and guidance from other groups, such as the actuaries, the accountants, and the regulatory authorities. There is reason to believe that the process will proceed in a regular and relatively smooth fashion and that the end result will serve the interests of policyholders and other publics of the industry.

MR. DONALD D. CODY: I am going to discuss the development and conservation of surplus as a basic quantitative ingredient in corporate financial planning.

My definition of surplus for a mutual company is the sum of unassigned surplus funds, special surplus funds, mandatory securities valuation reserve, and voluntary claim and investment fluctuation funds, all on a statutory basis; for a stock company, capital, contributed surplus, and retained earnings on a statutory basis would be added. In the absence of any GAAP guide for mutual life insurance companies, it is natural to use statutory financial statement figures. While admitting the additional degree of insight available from the introduction of GAAP treatment of deferred acquisition expenses, it is my feeling that consideration of the statutory surplus and changes therein gives adequate appreciation of the corporate mechanism for both short- and long-range planning. Mutual

life insurance companies do not have sizable surplus relative to assets, and thus the level of the statutory surplus cannot be permitted to fluctuate excessively.

Since the dividend is the release from the reserve mechanism in a mutual company, it is unnecessary, impractical, and wrong to adjust statutory reserves. Also, we have no need to show our net income on a basis comparable to industry generally in order to enhance the valuation of corporate stocks in the marketplace.

REASONS FOR SURPLUS

Surplus is needed by a mutual life insurance company for the following reasons, beyond the basic requirement for statutory solvency:

1. *Fluctuation in operating factors.*—A reserve against contingencies such as asset depreciation, claim fluctuations, or inadequate premiums, providing financial safety and shielding dividend scales from fluctuations in investment returns and claims. In many mutual companies, asset fluctuation is the major risk.
2. *New-business strain.*—Accommodation for the excess of reserves over asset shares on a growing line of new business (the increase in the new-business strain).
3. *Policyholder dividends.*—Generation of additional investment income to enhance policyholder dividends.
4. *Growth.*—Working capital for expansion into new lines and new marketing territory, for increases in agency force, and for congeneric subsidiaries. Working capital for expansion of systems (notably EDP) and services.
5. *Investment freedom.*—The ability to hold larger amounts of common stock, the market values of which can cause wide movement in the level of surplus; to manage the bond portfolio more freely; and to borrow long-term funds in the public market.
6. *Risk-taking.*—Financial strength to undertake bolder approaches for investment opportunities, underwriting procedures, and pricing decisions. Use of higher retention limits on life insurance with resultant lower reinsurance costs. Reinsurance capability in both life and casualty insurance areas.

SIZE OF SURPLUS

No adequate theoretical formula has been devised to indicate the appropriate size of surplus for a company with a particular distribution and size of insurance and asset risks and a particular long-range corporate plan. Beyond a minimum size judged by management as conservative enough to ensure solvency, surplus must be dependent on the long-range plan itself.

Charles L. Trowbridge, in his thoughtful paper "Theory of Surplus in a Mutual Insurance Organization" (*TSA*, XIX, 216), noted that pure asset companies, like mutual savings banks and mutual savings and loan

associations, seemed to be comfortable with average surpluses of about 7 per cent of assets, and that pure insurance companies, like mutual fire and casualty companies and mutual accident and health companies, had average surpluses of about 40 per cent of risk premiums. Taking these figures as formula measures, it is interesting to judge a company's surplus by calculating the ratio of its surplus to the square root of the product of its formula asset risk surplus (7 per cent of assets) and formula insurance risk surplus (40 per cent of risk premium). This ratio among large companies ranges from 50 to 200 per cent. The ratio can indicate the relative extent to which a company can undertake new activities and risks at a particular time, considering also its current level of operating gains and capital gains.

The adequacy of the level of surplus depends, of course, on such factors as size of company, level of premium margins, competitive net costs, valuation basis, existence of lower-risk business such as separate accounts and group annuities, state of EDP systems, health of field force, rate of growth, investable cash flow, persistency of business, and the like.

A study of the 1972 annual statements of one hundred mutual and stock companies with assets in excess of about $300 million indicates that surplus as a percentage of assets was distributed as shown in the accompanying tabulation. There was no noticeable trend by size or reserve

1972 Surplus as Per Cent of Admitted Assets	Distribution of Companies	
	Mutual	Stock
5	5 %	2 %
6	23	4
7	27	2
8	23	5
9	11	4
10	6	11
11	5	2
12	.....	4
13–15	.....	14
16–18	.....	27
19–21	.....	7
21–24	.....	11
Over 24	.....	7
Total	100 %	100 %
Average	7.5%	14.6%*

* Excluding the seven companies with surplus over 24% of admitted assets.

basis among mutual companies. The stock company percentages as a general rule increase inversely with size.

Stock companies on the average hold about twice as much surplus as a percentage of assets as mutual companies, reflecting no doubt their need for surplus because of their sizable term insurance risk, their ability to retain earnings and still enhance stockholder return through stock market values reflecting increased earnings and equity per share, and their more general use of modified preliminary term reserve valuation. Thus stock companies have a capacity for growth exceeding that of mutuals, at least on this score.

RELATIVE NEED FOR SURPLUS IN MUTUAL AND STOCK COMPANIES

Mutual life insurance companies as a general rule have developed loyal, well-trained, full-time agents in dynamic and well-organized managerial and general agency distribution systems. Attractive net costs enable these distribution systems to sell large volumes of business, and these agency systems have been our primary engine for growth.

In recent years both stock companies and mutual companies have begun to diversify into new kinds of financial services and congeneric activities, many of which are in the nature of additional distribution systems. We offer to the public new and different kinds of services beyond life insurance, accident and health insurance, and pensions.

Looking ahead, it is becoming clear that mutual and stock companies will continue to compete head-to-head in all these new markets. Both types of company have the need for growth to sustain corporate health. It is feasible and desirable for both to expand internally and through subsidiaries in new market, product, service, and investment areas, so as to enhance the earnings paid to owners whether they are stockholders or policyholders. The officers and directors of mutual companies have the obligation to preserve and develop the company in the interest of policyholders, both present and future. Both kinds of company serve the same public, and the quality and price of service to that public is the long-range determinant of ongoing success. Hence, corporate planning in stock and mutual companies would appear to have more similarities than differences. Retained earnings are just as important to mutual companies as to stock companies.

PLAN OF SURPLUS DEVELOPMENT

Long-range corporate planning relies strongly on financial analysis involving level of surplus and change in surplus, cash flow by line, and long-range financial projections. The basic objective is to keep surplus as a percentage of assets within a range acceptable on the basis of the

considerations already discussed. In attaining this objective, it is desirable to consider the increments to the annual increase in surplus in two groupings:

1. Operating
   a) Net operating income
   b) Changes in valuation basis
   c) Changes in not-admitted assets
   d) Changes in past-service company pension liabilities
   e) Assessments and recoveries of federal income tax
2. Capital
   a) Common stock; realized and unrealized net gains
   b) Fixed-dollar assets; realized and unrealized net gains, mostly of a planned nature associated with common stock market value movement; federal income tax planning; and portfolio management
   c) Subsidiaries, valued on a statutory equity basis

The investment plan affects and is affected by the operating plan. Effects of variable annual changes in the above items are smoothed over periods of time in working out the long-range plan. As noted earlier, GAAP procedures would appear to add discipline, depth, and further understanding to the above, but probably little change in this planning.

As a simplified example, a mutual company may find that a surplus between 7 and 8 per cent of assets is compatible with its long-range operating plan. When the stock market is low, the lower level is acceptable, perhaps even with some movement toward 6 per cent. When the stock market is high, the upper level is the goal, perhaps a little higher, toward 9 per cent. If assets increase on the average at about 5 per cent a year, surplus should likewise increase at 5 per cent nominally, but at a faster rate in a rising stock market so as to move the surplus percentage toward the upper end of the range or at a slower rate in a falling stock market.

Net operating gain after dividends is the most controllable factor in surplus increase, and the long-range plan must set a level of net operating gain to attain the surplus objectives, projecting the probable average level of capital gains and losses and the other variable operating factors noted. The interrelated investment plans for stocks and for fixed-dollar securities are significant.

Dividend scales, agency expansion, new products, new systems, new markets, and new activities must be undertaken within such constraints. Dividend scales, which are designed to recognize equity among classes and generations of policyholders, directly affect operating gain and hence surplus. New markets, products, and systems developed in the parent also

directly affect surplus. Subsidiaries have changing investment asset value in the parent equal to original capitalization plus ongoing contributed surplus plus adjustment for operating gains or losses of the subsidiary and for amortization of goodwill.

COMMON STOCK POLICY

The level of common stock holdings should ensure a low probability that at any time stock has to be sold to meet cash needs such as policy loans or investment commitments, to ensure a minimum surplus level, or to avoid excessively low investment income. Stock portfolios can realize their long-range capital appreciation advantages only as they are reduced by net sales when the portfolios are appreciated to such a point that total holdings surpass the company's policy level for stock holdings. Higher holdings of common stocks call for a surplus level and range which will tolerate wide movement of stock prices.

BOND POLICY

An adequate surplus level gives a company freedom to manage the bond portfolio so as to attain a number of objectives, involving the capability to absorb capital losses, such as the following:

1. Capital loss offsets of taxable capital gains arising from sales of stocks which have appreciated well above cost and would otherwise be locked in taxwise.
2. Improvement of investment portfolio and book earnings by sale of bonds with deep discount market values but held near par.
3. Swaps of bonds with deep discount market values but held near par, which will increase investment income through accumulation of discount, decrease current federal income tax, and establish a current capital loss with a deferred capital gain for tax purposes.

Capital losses from bond trading may average as much as one-third to one-half of capital gains from stocks over an extended period of time.

INVESTABLE CASH FLOW

For many years the major source of dividend improvements and operating gain has been the high earnings from investable cash flow from operations and from investment rollover. These earnings have exceeded the increasing costs of doing business caused by inflation. However, as assets have grown, this investable cash flow from operations has not increased proportionately except in pensions. Borrowing by policyowners of ordinary cash values for minimum deposit, for need, and for disintermediation reasons; low retention of policy proceeds in settlement options; slower growth of dividend deposits; and greater importance of term insur-

ance have conspired to lower the rate of growth in investable cash flow for ordinary business. Many companies have moved away from the middle-income market as we have upgraded our agents to sell in the sophisticated markets which do not look to the accumulation of cash values as an important fixed-dollar ingredient of their living estates. I anticipate that, as investment earning growth tends to slow down from this effect and from the peaking of portfolio investment yield rates, the level of bottom-line earnings needed to sustain surplus objectives may tend to inhibit continuance of the post–World War II trend of successive ordinary dividend-scale liberalizations.

In corporate financial planning, it is very enlightening to examine investable cash flow by line. You may find trends which are quite disturbing and suggestive of a future situation which must be prepared for.

CONCEPT OF RETURN ON INVESTMENT

In connection with large EDP systems, new lines of business through divisions or subsidiaries, services provided to the public or to agents for fees through divisions or subsidiaries, and new distribution systems, large expenditures sometimes extending over many years are involved. Frequently, the system, product, or service is optional, at least as to type of organization, extent, and sophistication. It is desirable to regard these planned activities as investments of surplus and to determine the return on investment, taking into account expenditures, fees, benefits, and savings anticipated. Within reason, the return on investment anticipated should be compared with similar return on invested assets. This equates investment in such ventures to be managed by the company with pure investments in industries or businesses run by others. This approach, normal in stock companies, is equally valuable in planning in mutual companies in order to clarify choice of options. The demonstration should be in accounting financial form projected over future years rather than in typical actuarial projection format such as asset share, so as to ensure communication with management.

CHAIRMAN ROBIN B. LECKIE: It appears that the audit guide will be revised to cover mutual companies, or possibly a second audit guide will be developed. In Canada we will have some form of GAAP for both stock and mutual companies. Will this produce more meaningful statements, and, if so, for whom? What is our role to be in defining the final principles adopted? And how will GAAP and the other questions of today, such as consumerism, affect the role of the actuary in a mutual company?

Both the actuary and the accountant are involved in financial management and reporting of a life company. In a sense they combine to play

the role of a modern management controller in a nonlife company. The accountant, by training, experience, and inclination, is typically concerned with income emergency and traditional accounting principles such as consistency, matching, and disclosure. He desires to provide management, and those to whom management is responsible, with the necessary information to judge the current performance of the enterprise.

The actuary, while concerned with income emergency, may concentrate his controllership on the balance sheet, the security of the enterprise, and the measurement and management of risk. His view is long term and future-oriented. He is also concerned with equity for all parties and between successive generations of policyholders. He feels responsible for ensuring that income and the distribution of income should emerge equitably, safely, and with reasonable consistency.

The actuary's work is complicated in that his projections and analyses are based not always on fact but frequently on judgment and probabilities.

Both the actuary and the accountant will be interested in the balance between assets and liabilities, but it is only the actuary who has the training to dictate and pass judgment upon the matching principles and the valuation concepts which should be used for each of assets and liabilities. Thus the actuary must be involved in setting investment policy.

The actuary is also involved in marketing—not only the design of policies and their provisions and the pricing of these policies, including dividend distributions, but the viability of the marketing operations and the fair remuneration for services rendered.

Thus the actuary, while playing his share of the controllership, becomes an adviser or a participant in every major function of a life insurance company's operations.

Unfortunately, too often the actuary while refining the detail fails to direct or alert management to its opportunities or longer-term problems. Both the actuary and the accountant tend to bury themselves in laborious analysis which may be necessary but must be considered secondary to the more general areas of managerial involvement—new ventures, financial competition, consumerism, surplus analysis.

The actuary is trained as a technician. However, the best actuaries must develop as generalists. They must be involved in the general dynamics of the whole business, since this is the most valuable contribution that can be made and certainly a necessary contribution for the company.

The actuary must play a significant role in the development and application of GAAP. This role was abdicated initially in the United States, and at one point it appeared that this might happen in Canada too.

Who uses the financial statements of mutual companies? Surely this is

the starting point in examining GAAP for mutual companies. Policyholders who own long-term rights will of course be concerned that the company be able to carry out its guarantees. They must also be concerned that the service, the investment, and the risk-sharing be provided at the lowest possible cost. Statutory statements adequately provide the former, while the policyholder must normally rely on management or regulatory authorities to provide the latter. GAAP may give some indication, but I doubt that any GAAP statement could actually assure the policyholder that he is insured with a well-managed company. Regulatory and tax authorities are served either by statutory accounting or by special reporting requirements.

Thus it is the rest of the life insurance industry and the internal management of a company that are the possible users of GAAP. However, the industry, in making comparisons among mutual companies, may be happier making across-the-board adjustments to statutory statements than using GAAP with its considerable variability from company to company (witness the experience of stock companies in the handling of the deferred acquisition expense asset). I doubt that management, particularly actuarial management, would rely on either statutory or GAAP statements as the sole means of developing internal information requirements.

I am not saying that GAAP should not be developed for mutual companies. I am saying that we should look carefully at how it will be used and who it is being designed for. Further, I would not like to see the companies saddled with a large expense burden for little general benefit.

The professional role of the actuary is changing or must change. The public wants more disclosure. They want the complexities of life insurance converted and disclosed in black and white, and the onus will fall upon the actuary to somehow make that happen. The prime purpose in preparing statutory statements has been to show that the resources of the company are sufficient to meet its obligations. Now, with GAAP, not only sufficiency but also appropriateness must be demonstrated, to give assurance that the company is not overly conservative.

I have always wondered why there have been so few actuarial papers or studies on the nature, the size, and the use of surplus in a mutual life insurance company. I hope we will see a great deal of activity on surplus theory in the next few years, for it is most relevant and needed with the various examinations or investigations taking place in our industry. Should surplus be a reasonably fixed percentage of liabilities, or should it vary, probably inversely, with rising interest rates? In what types of securities should surplus be invested? To what extent can it be used to fund new ventures? What constitutes surplus?

What about pricing and dividend policy in a mutual company? Should these be reconsidered, together with the concept of equity among policyholders and the contribution to surplus for the company as a going concern? Is it not imperative that there be a better understanding of how equity should operate? This will be fundamental in the design of a proper financial report of a mutual company. The emergence of the "release from risk" reserve theory in the past few years is a significant step toward a better understanding of risk emergence and policyholder equity.

What about implications of consumerism and, most particularly, cost disclosures? The interest-adjusted method has become a way of life but seems to be only a start to more complete disclosure. How can we adequately disclose projections when they are based on future performance assumptions? Will there not be a tremendous burden placed upon the actuary of a mutual company to project optimistic dividend scales so that the products of his company will compete with those of other mutual companies, where perhaps the actuary has been subjected to greater pressure from an agency-minded management? Will not the selling on price ultimately doom the agency system or at least the commission system? Would this be good for the industry? I do not believe so.

How about the relationship of the life insurance business with other ancillary services and businesses, such as mutual funds, pension administration, and property and liability? Is not the actuary a key individual in relating opportunities and advising management on the direction to go?

Going back to surplus, is not the actuary the one to advise management on the utilization of surplus partly as a protection for policyholders but more as a means to expand into new ventures or opportunities? Is not the actuary with his training the best equipped to make judgments? We must avoid being too conservative. We must learn to assess business risk as we do insurance risk and convey the elements of that risk to management.

The role of the actuary in a mutual company, during this period of reexamination and change in our industry, is a dynamic, necessary, and exciting one. More than ever we must fall back on the fundamental and technical lessons we learned years ago, but we must apply these with wisdom and general managerial understanding. We must be committed to the service this industry provides and yet we must see the opportunities that lie ahead. We must be conservative yet ensure equity. We must also be prepared to take risks and to encourage and guide our companies in doing so. Finally, more than ever, our role is to be the guardian and conscience of the company.

MR. KENNETH R. MACGREGOR: There is one aspect of the whole matter of GAAP accounting which gives me much concern. Attention has been focused on the desirability of deferring acquisition expenses in our financial statements. This is quite ironical in these highly inflationary times. Rapidly escalating expenses are probably the most serious problem confronting the industry, and attention is misplaced in pressing for deferral of any expenses. The emphasis should be on ensuring that adequate provision is being made for future expenses at much higher levels; yet comment on this most important problem has been conspicuous by its absence.

Actuaries know from their analyses of surplus earnings how the loss from loading has been steadily encroaching on other gains to the point where such loss has already offset the gain from mortality in some cases and is now partially offsetting the gain from interest. A few companies have recently made downward adjustments in dividend scales, and others are apparently considering doing so. In general, this must be attributed to rapidly rising expenses.

Inflation has, of course, had a powerful upward influence on both expenses and interest rates, but it would be folly to assume that rising expenses will be balanced by rising investment returns and, as a consequence, that the future will look after itself. There have been many periods (even in recent years) when interest rates were falling while prices were rising. Just as it has become obvious that common stock prices do not always follow closely the consumer price index but often move sharply in the opposite direction, so it should be obvious that high interest rates cannot be relied upon to match high expenses. Moreover, assuming that inflation can be brought under control and that interest rates return to more normal levels, it seems most unlikely that there will be any corresponding reduction in expense levels.

In the universal desire to achieve the most realistic system of accounting possible for life insurance companies, I suggest wisdom dictates that less emphasis should be placed on the deferral of expenses and far more on making adequate provision for future expenses.