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IMPACT OF THE 1980'S ON THE SURPLUS DISTRIBUTION PRACTICES OF MUTUAL COMPANIES

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RICHARD M. STENSON, THOMAS C. SUTTON

1. Will investment generation practices become more prevalent in the 1980's?
2. Will the current trend of decreasing gross premium and dividend levels continue?
3. Will the anticipated necessity of actuarial opinions on the Company's surplus distribution practices become a reality? If so, what form will it take?
4. Will any outside group exert a direct influence on a Company's dividend practices in the 1980's?
5. Will higher or lower surplus levels be appropriate for the 1980's? Will the source of Company surplus growth be similar to that of the 1970's?
6. Will the market for life insurance and annuities grow as rapidly as Company growth objectives demand? If not, what will be the likely results?
7. Will a continued high level of inflation create pressures for surplus distribution practice changes in the 1980's? If so, what changes are likely?

MR. THOMAS C. SUTTON: Speculations about the future are always interesting, but rarely accurate. The value of speculation is in the process of stretching the mind to see a new emerging reality. My comments this morning are intended to provoke thought and discussion. They are not intended to be prophecies; however, I believe that there is a reasonable probability that the events I mention could actually occur. Translated, this caveat means that in 1990, when I look back on these comments, I want to be able to disclaim any which then appear foolish, while at the same time I want to be able to take full credit for any which turn out to be accurate.

The context is the High Inflation Scenario described in your program. This scenario is the one which we probably all believe is most likely to occur. The key elements of the scenario that bear on my remarks are these:

1. Continued double-digit inflation
2. Lack of consistent, national economic policy for more than 18 consecutive months
3. Indexed tax structure and federally mandated wage indexing

4. Widespread class action suits and organized, influential consumerist groups
5. Repeal of McCarren-Ferguson Act
6. Mandatory F.T.C. cost disclosure
7. Continuing increase in life span
8. Increase in public's "present-mindedness," along with decreases in saving, investment and planning in the future

In this type of environment, what major changes will have taken place by 1990? Let me describe some possibilities and their background. For a while now I am going to be speaking as if it were already 1990.

Investments

The bond market crash of '80, coupled with the frequent shifts in monetary and fiscal policy of the federal government, has resulted in a radically different investment climate during the last ten years. Long-term bonds as such have ceased to exist. They were replaced mainly by quinquennially renegotiable bonds analogous to the mortgage loan instruments introduced in 1980. As a result, the effective average lifetime of insurance company investments is now about four years, and some observers say that is too long. In contrast, the nominal policy loan rate on traditional life and annuity policies has remained at 8% ever since the establishment of the Federal Insurance Department (F.I.D.). There are those, of course, who believe that the Federal Insurance Department has not changed the loan rate as a deliberate step designed to eventually eliminate traditional permanent policies. And since most policies these days have their cash values fully borrowed, the F.I.D. may accomplish that.

For the sake of completeness, I should remind you that the Federal Insurance Department was an almost immediate result of the repeal of the McCarren-Ferguson Act. State insurance departments, of course, did not disappear overnight. However, budget pressures in the various states eventually resulted in the dissolution of that regulatory duplication. I should mention, of course, that the elimination of the state regulation did not result in the elimination of the state taxes on insurance premiums.

Dividend Constraints

Another event, spanning several years in the mid 1980's, was the class action suit between one of the industry giants and many of its policyowners whose dividends decreased as a result of that company's 1983 scale change. Eventually the case went to the Supreme Court and was decided in favor of the plaintiff class. This landmark decision was soon followed by the Federal Insurance Department's regulation on dividends and other non-guaranteed elements included in insurance and annuity contracts. In essence, this regulation states that any such elements illustrated or displayed to the policyowner at the point of sale must be paid unless the solvency of the company is threatened and the Federal Insurance Department specifically approves the size and manner of dividend scale reductions. This regulation has had a dramatic effect on the contribution principle of surplus distribution. That is to say, that principle is extinct. Instead, most

companies have espoused a dividend bonus system under which the actual policy dividend on traditional products is the sum of the dividend illustrated at the time of sale, plus a bonus addition. The bonus addition is generally a uniform percentage of the illustrated dividend.

Cost Disclosure

Moving to another area of importance, I remember that when the Federal Insurance Department took over regulation from the states, its first action was to mandate cost disclosure along the lines previously advocated by the Federal Trade Commission. Buyers had to be told:

- The effective yield rates on permanent insurance and
- Commission rates and commission amounts on all sales

This led to a number of changes. One was a flattening of commission scales, which in turn had considerable implications for the marketing force, but I'll cover that shortly.

As far as product changes, the clear communication to the buyer of the bulk of the initial sales charges negated the previous obfuscatory elements of the complex standard nonforfeiture value calculation. Let me rephrase that. Minimum cash values under the law used to be calculated prospectively. One result of that approach was to obscure initial expense charges and make them less obvious. But after mandated direct disclosure of the bulk of those expenses, that particular reason for the prospective approach was gone. This in turn led to a new cash value law based on retrospective accumulations. This action had two offshoots, one minor and one major.

The minor one was the elimination of flexible products of the adjustable life design. This was natural since most of the structure and complexity of adjustable life arose because of the old valuation and non-forfeiture laws, coupled with heaped front-end commissions.

The major offshoot was that, due to the fact that in determining the cash value retrospectively, the company was permitted to credit an interest rate higher than the minimum specified in the law. That higher rate, used for the most recent policy year update, has been interpreted to be the valuation interest rate in applying the Menge Rule and calculating federal income taxes.

Under these circumstances, it was greatly to the advantage of the company and the buyer to credit the highest possible interest rate in the cash value calculation and so the interest element of the annual dividend was eliminated.

But back to the direct issue of cost disclosure and the mandated effective yield rate. The industry had long decried the yield rate approach to cost disclosure as an inappropriate measurement, but in the end we were saddled with it. So we took steps to make it meaningful, and this process was assisted by the changes in cash values and taxes I just mentioned. The other element in the yield

calculation is the price of term insurance. Since companies used their own term rates in computing yields, there was some initial reverse competition on term prices; but that was soon swept away because of the growing importance of term sales.

Term Insurance

In the last ten years, term insurance has been subject to phenomenal growth and considerable regulation. Term's continuing popularity, of course, has several causes. First, its low immediate cost represents an orientation which corresponds to the buying public's "present mindedness."

A second, but closely related reason is the constant double-digit inflation which has reduced effective buying power and narrowed the options reasonably available to buyers. In direct words, term insurance is all that most people can afford. This is especially true since nearly all term insurance sold is now indexed. As term sales became more and more important, price competition became cut-throat to the point of irrationality. Back in 1980, I remember seeing an advertisement in the National Underwriter for annual renewable, annual re-entry term with first year commissions every year. This is a product that has incredibly low premiums each year that the insured qualifies based on regular evidence of insurability. I thought that was the ultimate in term. But no. It wasn't long after until that product was modified to permit re-entry without evidence of insurability, but still using the first year select rates. It then became obvious, if it wasn't before, that under competitive marketing pressure there is no product idea that is so absurd that someone cannot invent a rationalization for it. In any case, it wasn't long after that until several insolvencies resulted in the 1984 Federal Insurance Department regulation on renewable term. The highlights of that regulation were these:

- Premiums and dividends for all renewable term coverages must be independent of policy duration. That is, rates must be determined by attained age only.
- The net cost charged on new renewable term policies must not be less than the net cost charged for the same attained age, sex, and underwriting class on any previously issued renewable term policy.

This regulation certainly did put renewable term pricing back on a sound basis. It also mandated a direct, obvious connection between term costs on old and new policies. That fact and the yield rate cost measurement approach has resulted in substantial price consistency between new and old business of all types.

Marketing

What happened to the marketing force as all these major changes were occurring? Clearly, there was a great deal of trauma, but despite the changes many of the basics have endured much more readily than many expected to be the case in the early 1980's. There was a polarization of marketing types with two major survivors. One is the

"department store" pre-packaged type of sale in the middle income markets, and the other is the full financial planning type of sale in the upper income markets. Compensation for the former group is on a salaried basis, but for the latter it is an interesting combination of:

- Level commission rates on product sales,
- Base salary and incentive bonus from the primary company, and
- Consulting fees negotiated between the agent and buyer.

The career agency companies which moved to that basis chewed up a lot of surplus in the transition, but the results now appear to be very worthwhile.

Now let's jump back to the here and now. The hypothetical changes I have described will all have an impact on surplus and its distribution. That's the measure of the importance of the topic. Surplus distribution is the bottom-line result of investment policy, underwriting, product development, marketing, expense control and every other major activity of a life insurance company. Aside from affecting surplus, the hypothetical changes are all intertwined with each other, with mutual causes and effects. Actual events will naturally be different than those I describe, but I think it is necessary to go through a mental exercise like this in order to create a more detailed framework within which we can then develop answers to the questions which have been posed in the program.

Questions

1. Will investment generation practices become more prevalent in the 1980's?

In the early 1980's it is quite possible that the increasingly acute competitive environment will push a few more companies to use an investment generation system for individual dividends. However, I think that over the decade the changes in the investment environment will be such that the difference in product price between the two methods will diminish. If the average lifetime of an investment truly becomes four years and if most policies are heavily loaned, clearly there is not going to be a material difference arising from these two approaches.

2. Will the current trend of decreasing gross premium and dividend levels continue?

Yes and no. In talking about traditional products I think that most companies will have plans of insurance with minimum levels of premiums and low dividends but at the same time those companies will also have other plans of insurance which have relatively high premiums and high dividends. Reasons for the latter include maintaining agent compensation levels and the trend toward longer and longer range cost measurement methods used by sophisticated agents.

3. Will the anticipated necessity of actuarial opinions on the company's surplus distribution practices become a reality? If so, what form will it take?

Yes, it will become a reality and will probably take the form of a certification to be made by the industry. The certification might include an assertion that generally accepted actuarial principles have been followed, but it may also include representations concerning the expected future lifetime of current dividend scales. One element of the scenario I described is that components of price were made much more visible by legislation. This resulted in a forced apparent price consistency and removed the need for extensive reliance upon representation made by the actuary.

4. Will any outside group exert a direct influence on a company's dividend practices in the 1980's?

Yes, and the outside groups will include: Consumers, possibly class action plaintiffs, and it will certainly include the regulators.

5. Will higher or lower surplus levels be appropriate for the 1980's? Will the source of company surplus growth be similar to that of the 1970's?

Currently the greatest need for surplus exists because of investment risks. The risk which is most acutely evident at the moment is that of market value loss as interest rates increase rapidly. This risk will diminish substantially as the average lifetime of investments decreases and as policy loans increase. This reduced risk, coupled with political pressures on the size of the surplus, in a downward direction, will result in lower surplus levels for the 1980's. While the source of surplus growth can be analyzed in a variety of ways, I suspect that for most major mutual companies the net growth in surplus will be less than the after-tax interest earned on previously accumulated surplus.

6. Will the market for life insurance and annuities grow as rapidly as company growth objectives demand? If not, what will be the likely results?

The market for term insurance will probably grow more rapidly than the capacity of the associated marketing mechanisms to tap that growth. The market for traditional permanent insurance will continue in very high income markets, assuming there is no basic change in the income tax structure; but the overall growth rate will be far less than that for term insurance. There will also be a significant growth in non-traditional products that package term insurance with annuities or term insurance with money market funds.

7. Will a continued high level of inflation create pressures for surplus distribution practice changes in the 1980's? If so, what changes are likely?

Yes, there will certainly be pressures for changes but the form they take depends very much on the details of events that develop. In my hypothetical happening I alluded to a number of conceivable changes.

Conclusion

In any case, the future will be substantially different than the present, and it will arrive posthaste whether we are ready for it or not. I hope we will be ready, not only to accept and capitalize on the future, but to help share the events over which we have some control.

MR. DONALD B. MAIER: In order to prepare for this presentation, I asked our Company's economists to give me an analysis of the Investment and Incentive Scenario. The following are some excerpts. The likelihood is virtually nil. This would be a businessman's utopia which makes excellent economic sense, but which is not realistic from a political point of view. Possible precursor conditions would include a desperate economic situation sufficient to cause a pronounced shift in the political posture of most elected officials.

The economy would likely feature a high rate of growth, strong productivity gains, a rise in living standards, rapid growth of the private sector, more orderly capital markets with lower interest rates, and a favorable equities market.

In other words, we would really have about as good a situation as one could imagine for the sale of traditional life insurance policies and annuities. Such long-term purchases would be encouraged by the new "rugged individuals" with its emphasis on self-sufficiency and individual independence.

The combination of the trend toward lower interest rates together with the encouragement of increased competition could put a real squeeze on our pricing assumptions, and I will discuss this a little more as I respond to the individual questions.

1. Will investment generation practices become more prevalent in the 1980's?

Considering the three scenarios, the Incentive and Investment Scenario would be the one that least encourages investment generation practices. The decrease in the rate of inflation associated with this scenario can reasonably be expected to be accompanied by a considerably lower general level of interest rates. This scenario would seem to indicate a general leveling of interest rates at around an 8% level (5% for inflation plus the theoretically underlying 3%). This would undoubtedly remove the competitive pressure which might otherwise encourage an investment generation approach for life insurance.

As a matter of fact, it would seem that the portfolio method might be especially appealing to those companies where a significant portion of the portfolio may have been invested more recently at higher rates of interest than might be available in 1986 under this Incentive and Investment Scenario.

Of course, the elimination of the corporate income tax would have the impact of increasing the interest rates which could be used for dividend distribution.

2. Will the current trend of decreasing gross premium and dividend levels continue?

In the case of permanent insurance the major source of lowering gross premium levels has been the use of higher rates of interest for nonforfeiture values. If a level of interest rates does materialize at a rate somewhat lower than is prevalent today, it would thus appear that the trend toward the use of higher interest rates for valuation and nonforfeiture purposes would not continue. Perhaps this scenario implies a trend toward even lower interest rates. Of course, in that case it would seem to call for more conservatism, that is, higher gross premium levels.

On the other hand, this scenario indicates the prevalence of competition. More banks and perhaps more insurance companies would be competing for the life insurance dollar. This would imply competitive pressure to continue to lower gross premium levels. If it cannot be justified by lower nonforfeiture values based on higher interest rates, then it presumably would need to come from other factors. Some gain would, of course, come from the impact the health breakthroughs would have on mortality assumptions. However, for permanent insurance we might expect the more significant competition on the basis of expense margins.

The social climate indicated by this Incentive and Investment Scenario might make life insurance sales easier, and this together with increased competitive pressure might be sufficient to bring about lower commission levels.

On term insurance the health breakthroughs would, of course, have a more significant impact on premium levels. This is an area where one might speculate, as some are doing today, whether overly optimistic assumptions might lead to ultimate trouble.

3. Will the anticipated necessity of actuarial opinions on the company's surplus distribution practices become a reality? If so, what form will it take?

While I would expect that Tom Sutton, who is a member of the Academy Committee on Dividend Practices, will give you a better indication of where that Committee is going, it does seem to me that they expect the answer to the first part of this question to be "yes." I will leave it to Tom to discuss the likely form

that such opinion will take. It will be particularly important under the Incentive and Investment Scenario in view of this scenario's increased encouragement of competition. Heavy competitive pressure generally pushes in the direction of finding a theory that will improve sales illustrations at a minimum cost.

4. Will any outside group exert a direct influence on a company's dividend practice in the 1980's?

I would hope that the answer to this question is that the work of the Society of Actuaries' Committee and the Academy Committee will have influenced at least a few companies to change their practices to be in conformity with the recommendations and interpretations developed by those Committees. On the other hand, I hope it does not go much further. I know that the thrust of the Society Committee's work has been to initially define its regulations rather broadly with the hope that they or the Academy Committee will be able to tighten the definitions as things develop. However, I would also hope that this does not start a trend which could be continued to where we begin to experience undue regulation of dividend practices.

5. Will higher or lower surplus levels be appropriate for the 1980's? Will the source of company surplus growth be similar to that of the 1970's?

Under the Incentive and Investment Scenario, I can see at least three pressures which would influence surplus levels:

- a. A trend toward lower interest rates on investments would, of course, theoretically indicate the desirability of building surplus especially on outstanding business where fairly high interest rates have been assumed in premium rates and nonforfeiture values.
- b. Health breakthroughs might be felt to be an indication of even greater improvements to come, in which case lower surplus levels would be justified.
- c. Competition generally exerts pressure toward lower surplus accumulations for the sake of an improved competitive posture.

I would expect that the sources of surplus would be similar to those of the 1970's except that under the Incentive and Investment Scenario a trend toward lower interest levels would squeeze this factor. On the other hand, the elimination of capital gains taxes under this scenario would seem to indicate that this would encourage more investments of the type that could produce capital gains as an increasingly important source of surplus.

If capital gains do emerge as an increasingly important source of surplus, it will necessitate the development of a proper method of equitably recognizing this source of surplus among

generations of policyholders, especially where a lower interest yield is accepted today in exchange for a capital gain anticipated in the future.

6. Will the market for life insurance and annuities grow as rapidly as company growth objectives demand? If not, what will be the likely results?

The Incentive and Investment Scenario, with its emphasis on "self-sufficiency and individual independence" and "saving and investing like the Japanese in the 1970's," would indicate real opportunity for traditional life insurance company products. This particular scenario would seem to be the best hope for the whole life insurance policy to continue as a really viable product. The other scenarios would generally seem to encourage the trend toward term insurance and annuity sales. In this latter situation one can speculate on a significant change in marketing practices and commission structure. The heavy emphasis on competition under the Incentive and Investment Scenario can have a similar impact. As I indicated earlier, heavy competition may exert pressure on commission rates and other sales compensation.

7. Will a continuing high level of inflation create pressures for surplus distribution practice changes in the 1980's? If so, what changes are likely?

It is generally agreed that a major result of inflationary trends will be to accelerate the general tendency to move away from permanent insurance toward more term insurance with a corresponding increase in the sale of annuities and other investment-type products on the part of life insurance companies. It seems to me that it would be quite important for companies to develop model offices to reflect this kind of an environment. A major concern will be the extent to which the current marketing organizations can be supported with these types of products.

Quite aside from inflation, I wonder if the variable premium concept currently being developed by many stock companies will also become more prevalent in the case of participating insurance issued by mutual companies. Renewable term insurance could be particularly suitable for this kind of arrangement.

In the case of annuities we have already seen a major shift to an approach of participation in the interest area by specifying a minimum guaranteed rate with an indication that the actual payable rate will be set by the company from time to time. In both cases, variable premiums and annuities with variable interest rates, there may only be a small area left for other dividend margins, if any.

Under the Incentive and Investment Scenario, we would appear to have the least impetus for a major change in the surplus distribution system. The major disruptive factor under this scenario is the competition element. Increased competition generally tends to push in the direction of less conservatism in pricing and we may trend toward the kind of situation that is currently prevalent in the health insurance field; that is, in spite of the fact that policies are nominally participating, competition generally may not permit the inclusion of significant margins that would later be returned as dividends.

MR RICHARD M. STENSON: I would like to begin by a very brief overview of how I see the Social Democracy Scenario affecting life insurance and annuity products in the U.S., in a sense to assess my own gloom level about this scenario although it is not as deep as the level that I've heard from some of the participants so far.

In the first place I think it would have an effect on competition between companies in the sense that there would be less of a competitive factor in the traditional sense, in the sense of companies trying to build increased market shares in the old Adam Smith capitalism sense. More emphasis is in this scenario on national planning, worker and customer ownership, a feeling of business as usual and a continuation of the status-quo. On the other hand, this scenario carries with it a probable very strong regulatory overtone; regulation from the federal government, consumer-oriented regulation, cost disclosure studies, shoppers' guides, etc. Competition would be defined in terms of whatever cost index happens to be currently in favor among the federal regulators then holding sway. The marketing impact of this scenario shows increased social security benefits and increased in-roads into the low-to-middle income market. In fact, there may not be a market for private individual insurance and annuities under this scenario for those people. On the other hand, there would continue to be a death benefit protection market focusing on young professionals and executives. It may be a current-needs kind of market, a right-now kind of market, a term insurance oriented market. For more established people it is obvious that this scenario produces increased taxes. Estate planning, corporate fringe benefits, and business insurance for established professionals and executives may be the remaining market for individual permanent life insurance. A lot of that may depend on the tax treatment. I don't have an answer here under this scenario since I am not sure what value-added means for life insurance. If the tax treatment, however, of the individual life policy itself continues to have the inside build-up feature and life insurance death benefits the current feature, I think that the permanent insurance market in the estate planning and business areas would remain significant.

I think this scenario, as well as many of the others, could lead toward more term insurance products. The disclosure and regulatory climate would be a part of the reason. Many of us may end up in the buy-term-and-invest-the-difference business whether we like it or not. Adjustable products with the emphasis on the life cycle treatment could continue. It would be certain that there would be heavy regulation of proposals and of sales methods under this

scenario. In terms of sales and distribution of the products, this philosophy and the regulatory climate giving probable up-front commission disclosure could lead toward more level commission patterns, it clearly could lead toward less difference or no difference between term insurance commission rates and permanent insurance commission rates. I think this scenario carries with it, despite wage and price freezes that are mentioned in the scenario, a continued expense squeeze on life insurance companies. Inflation is moderating but only in comparison with the first scenario. 5% is not a low inflationary rate for the long-term level. There would be additional cost pressures from social welfare concerns, such as programs for hiring unemployables and concern with better benefits for employees. I think the whole thing would end up in an expense squeeze on companies that do rely a great deal on people, such as is true in the life insurance and annuity business.

The first question dealt with investment year method practices; would they become more prevalent under this scenario? In a sense it depends on what this scenario would do to the continued climate of the investment market and the competition from other financial intermediaries. This could have a strong influence. This scenario could result in long-term pegging of investment returns, national planning, an attempt to run with a planned economy on a national basis, and reduced differences in rates of return between longer-term and shorter-term investments and between older and new investments. It could render the whole thing academic. But, it is more likely that the relatively high inflation rate would continue to give us a relatively high interest market. We would have an emphasis on competition with other investment media if a permanent insurance market continues. These sorts of alternatives might lead to more movement toward investment-year method practices for individual life. Certainly, they are already common in the annuity market.

In terms of gross premium and dividend levels; part of the movement toward lower gross premiums and lower dividends comes from improved mortality. I expect that to continue under all the scenarios, and a movement would continue in this direction in the Social Democracy Scenario unless there is some sort of arbitrary pegging of investment returns to get investments arbitrarily low. There also would be a tendency in the regulatory climate with probable proliferation of cost disclosure and with general consumer attitudes changing to tend toward an emphasis of going in cost and de-emphasis of longer term build-up of dividend credit.

Actuarial opinions would certainly become a requirement under this scenario. I do hope that the actuarial profession is able to come up with a meaningful and significant series of professional guidelines for us to use which would enable the actuarial profession to have quite an influence in whatever actuarial opinions are adopted. It will be an evolutionary practice in a sense, though, that will produce changes in these requirements. This scenario would result in the emphasis on actuarial opinion focusing on allocation of dividends to existing customers to a large extent because of the customer-management influence that goes along with this way of looking at the future. The federal regulators will be concerned with meaningful disclosure on new business illustrations.

Outside groups attempting to influence dividend allocations would be largely the regulators, if they are outsiders, and consumer advocates. The regulators would have the most direct impact. The regulators, however, may view their constituency under this sort of an arrangement with a very consumer-oriented federal regulatory process. They may view their constituency to be consumer advocates rather than policyholders. This could cause them to press for an oversimplified dividend process. They would feel the need to have the dividend process look as simple to the customer as the allocation of surplus that an industrial corporation makes and simply require an allocating of an amount of dividend to pay to the shareholders and a dividing by the number of shares. Nothing would be simpler in life insurance than to divide by the face amount of insurance per thousand or the amount of premium, but that is not a very equitable allocating system. That is certainly not going to happen, but oversimplifications could result in a way that would hurt relative policy equity.

I don't think that this scenario would call for significant changes in the relative surplus levels that companies would hold. The surplus level should be related to long-term considerations of the amount needed as a sufficient cushion against adverse contingencies. Relative levels of that would not be affected largely by this scenario. It could result in some consumer-orchestrated pressure to distribute more in dividends than might be appropriate.

This scenario would be very susceptible to political pressures, the kinds of things that we occasionally see in the newspapers suggesting that insurance company reserves are so conservative that insurance companies are sitting on huge amounts of surplus that should be paid out to the customers. It is possible that a political movement of that kind could develop under this scenario. State insurance department regulators, however, would be focusing on solvency, and they would become a strong voice of responsible conservatism in this area. You also would have worker interests represented in companies who would operate to assure the continued health of the company.

Sources of surplus earnings will continue to come from margins in mortality and investment with a containment of expense growth continuing to be a problem under this scenario, even though it is not as explosively inflationary as the first scenario.

Markets can grow as rapidly as company growth objectives demand with this scenario (and maybe I am a little more optimistic than others, but not easily) and do so on a cost-effective basis. The real problem will be to keep unit expenses of doing business from worsening considerably. People costs, as I have mentioned, will be forced upward under this scenario, again despite so-called wage price freezes. It's got an emphasis on high living standards and full employment.

Companies will have to learn to use product development and to rely on worker involvement in company management in positive ways -- ways

which will ensure increased productivity both in sales and administration. The alternative is increased cost of products in an environment where social welfare programs will foster an element of discretion as to the purchase of financial security instruments such as insurance and annuities.

Now the last question that we have deals with high inflation interest rates if continued, and this scenario also implies that. These will create some pressures for a greater interest element in dividends, and as I have mentioned, there might be more use of investment year methods in insurance dividends. Variable life or other similar products are another possibility that may begin to see more usage if this sort of thing continues. Should the policy loan crunch continue and become more and more serious, as caused by high outside interest rates, direct recognition of policy loans and dividends on a policy-by-policy basis or some uncoupling of the interest rate above the current 8% maximum is a possibility, although not a very easy one to see its way through into completion.

MR. ROBERT D. HOGUE: Can mutual company term products be made more competitive in the future?

MR. SUTTON: There is no theoretical reason why a mutual company cannot compete with a stock company on term insurance. As a matter of fact, in theory having no stockholders means one fewer group to satisfy in some economic sense. One would think that a mutual company could be more competitive than a stock company. At a more basic level, "competitive" should not include irrational competition. The larger companies, whether stock or mutual, are less inclined to have policies that have no economic justification in terms of profitability. There may be a greater tendency on the part of some small stock companies that are desperately trying to survive to have premiums at a level that no one can compete with rationally. I would hope that that would be short-lived. In the scenario that I described it resulted in some insolvencies and some accompanying regulation. That is purely speculative, but I can see how that could happen, so it does depend on how far you take "competition."

MR. MAIER: Under the Incentive and Investment Scenario you would have the least motivation to offer overly competitive term insurance.

MR. STENSON: The reasons often given why a mutual company could not compete with a stock company or with a non-par policy presumably relate to the fact that the non-par policy may make money, or it may lose money, and the par policy profits are paid out in dividends, so you don't have the "up side." I don't think you have the "up side" in renewable term insurance in any event, not even in a non-participating product because nothing could be replaced more easily and is replaced more easily than renewable term insurance. I, too, see no inherent reason why a mutual company cannot compete in the term insurance market. They do have to be willing to shave dividend margins, and that may be a movement in the future.

MR. ROBERT M. ASTLEY: If a company is investing long, which is what the life insurance industry now does but provides cash and loan value

guarantees (i.e., guarantees of par), then it is totally mis-matched. Any scenario with rapid change in one direction or another is a very unstable situation. A number of companies are going to feel the pressure to reconsider, in respect of their individual participating business, whether the long-term investment strategy is still appropriate and even if long bonds continue to be available whether they are proper vehicles for that amount of money.

MR. STENSON: One of the strengths of the permanent individual life policy is its front-end load because it becomes an investment selection charge in a sense. Individuals who wish to replace a life insurance policy with a front-end loaded commission and expense basis have a lot to lose, and that makes up some of the difference. The leverage that a discontinuity of interest rates can produce on a life insurance policy is a lot less than on an annuity contract.

MR. ASTLEY: Companies are going to take a much better look at what their surplus needs really are. The Leckie paper gave a method. Companies will start trying to assess their needed annual permanent contribution to surplus, if they are on that kind of philosophy, to move towards that basis as a rationale for surplus levels.

MR. MAIER: Every one of these scenarios has these two influences in them that are contradictory. The one is that each one has a heavy input from consumerists (who are regulators) which pushes you toward distributing more and being more competitive, and therefore holding less surplus. And, each is a catastrophe which would of course indicate that you can never have enough surplus. While none of them is very likely, they all have elements that we probably ought to have in mind. It is becoming increasingly important that we look at our surplus in new ways in view of the kinds of things that look like they are coming about.

MR. SUTTON: One way to look at it is almost from the reverse. That is, if it becomes competitively necessary or politically necessary to reduce surplus; how do you reduce some of the risks for which you owe surplus? If one of the risks for which you owe surplus is the investment risk, then you can reduce investment risks through a variety of means by basically changing the nature of the types of investments that you have. Whether it is because of a conscious effort or because of a lack of long-term investments available, you come to the same bottom line.

MR. OWEN A. REED: You can debate the question about what the High Inflation Scenario will do to surplus levels for some time on rather interesting sides of the question. It seems intuitive that if you stick with the current rate series, whatever it is, high inflation and high growth will cause companies to eat into surplus. On the other hand, if you do realistic pricing you would have to argue that if the existing policyholder is providing the surplus to write the new business, they should expect a reasonable rate of return. Then, the higher the inflation rate the higher the return they should expect before you have to increase your premium rates to provide the

higher return. If this higher return is almost immediately distributed to the existing policyholders, then a company would not start eating into surplus. I'm in the camp that feels that the market for participating insurance in absolute terms, that is in real gross terms, is going to diminish if inflation continues the way it is.

I am also a little dubious about these remarks about reducing the investment risk. In my own company's studies, a fund from one year's issue of permanent insurance builds to a peak something like 32-33 years from issue and then drops off. Therefore, one key question is how long you expect to maintain the dividend scale on this business that you have issued. Depending on the answer that you get to that question, I think you might find that you might need even higher investment reserves.

MR. SUTTON: I would certainly agree. If we do move to shorter and shorter term investments, we will have to learn to live with more frequent changes of dividend scales in both directions.

MR. HOGUE: Under the High Inflation and Social Democracy Scenarios there was an allusion of changes in the source and distribution patterns of company surplus and how that money flow would radically change from past practices which would be most exemplified by the Incentive and Investment Scenario assumption.

MR. STENSON: One possibility that could happen would be movement toward more projections. I don't think it is right, because the dividend should reflect experience, and if experience changes I think the dividend should be changed. There are underlying patterns, however, in some of the scenarios, in the growing consumer movement, and in possible political influences to come to play that may move us in this direction. The dividend philosophy work (of the Academy Committee on Dividend Practices) is continuing to go in the direction of the contribution principle. There are overtones, though, to statements that should be made with respect to dividend scales that cannot be held for the very near future, and this is an influence that may come to play.

MR. MAIER: I do not see much reason to change the contribution principle or the formulas that we use so much as to be careful of the kinds of factors that we are evaluating as we set our dividend scales. How many of us have run out model offices that look to a time when even greater proportions of our current business are out on policy loans, or how many of us are running out a scenario which looks to an accelerated rate of surrenders and considers what the impact will be on the expense factors that we are currently using in our dividend formulas? We really ought to be using asset share and model office approaches that also factor in the other dynamic things that can happen in the '80's.

MR. SUTTON: I agree in a sense that there is no particular reason to change the methods that we use to calculate dividends. They are really an approximation to some more sophisticated approach that is used for actually determining what the allocation should be. There is no particular reason to change those; but if you create a scenario and an environment with a lot of different inter-active forces,

including the tax law, regulations, the marketing force, the consumer, etc., you can go down a chain of thought which leads you to make significant changes in how you formulate dividends. I went through one of those that would result in removing the interest element, essentially, from the nominal dividend and putting it into the cash value increase.

MR. REED: With respect to revised dividend practices and principles, I would want to reflect a link-up between dividend principles and valuation principles. Certifying a valuation of liabilities and certifying dividends forms an unbreakable link.

MR. SUTTON: There is really more than one perspective. The Society is setting down principles of equitable distribution without regard to financial statement impact. Those principles would be implemented to the extent that they can be implemented by the Academy and by the Canadian Institute of Actuaries. The Academy's Committee has not contemplated any simultaneous change of valuation laws.

MR. STENSON: The Academy Committee has been discussing the issue of disclosure, with emphasis on the contribution method. This is in the Society report as well.

MR. PAUL T. BOURDEAU: I would like to ask the panel if they feel that actuarial certifications are in the public interest. If they are, why? If they are not in the public interest, why are they an anticipated necessity in the program?

MR. MAIER: There are a lot of variations in practice with respect to dividend distribution, especially with respect to attitudes toward illustrations. In the climate that we are in it becomes much more important that dividend illustrations be on a reasonably consistent basis. I would hope that a publicity of accepted methods of dividend distribution, illustration, and certification would tend to bring about a uniformity of practice.

MR. BOURDEAU: It sounds a bit like we are seeking to regulate ourselves. There is enough regulation. Is this in the public interest? In our business we bring half or three-quarters of the regulation on ourselves.

MR. MAIER: The impetus for this comes from the concern that if we don't do it ourselves we will get the regulation forced on us by people who don't understand our business.

MR. STENSON: It is very much in the public interest for us to regulate ourselves.

MR. SUTTON: It has the intense interest of a couple of N.A.I.C. committees, as well as the Society's Committee and the Academy's Committee. We provide them with regular reports and so far have had good communication with them. But, there certainly is the fairly strong feeling in some quarters that if we don't come up with an approach, or if the approach is completely unacceptable, that others will get into the act.

