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THE IMPACT OF A CHANGING ENVIRONMENT ON PERSONAL SECURITY PROGRAMS

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1. Regulations
   (a) ADEA
   (b) Mandatory Maternity
   (c) Buck Decision

2. Taxes

3. Consumerism

4. Social Security

5. Age/Sex Composition of Work Force

6. Inflation

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MR. DWIGHT K. BARTLETT: Discussion Note--

DEMOGRAPHIC ASPECTS OF SOCIAL SECURITY

INTRODUCTION

Why do demographic trends affect Social Security? The OASDI program operates under a current-cost method of financing by which the benefits to today's beneficiaries are paid from the taxes of today's workers. Therefore, the year-by-year changes in the benefits of the program and the taxes required to support them are directly related to changes in the number of beneficiaries and the number of workers. The number of beneficiaries and workers--and therefore Social Security's financing status --varies according to demographic trends.

How can the effect of demographic trends be evaluated? One measure of demographic trends is the pattern of the so-called aged dependency ratio, the ratio of the population aged 65 and over to the population aged 20 through 64. Between 1979 and 2035 the aged dependency ratio is projected to climb from .193 to over .360. A similar, but more precise measure (for Social Security's purposes) is the number of OASDI beneficiaries per 100 covered workers. The number of beneficiaries per 100 covered workers is projected to climb from 31.3 to about 50 by the year 2035. Social Security's cost as a percentage of taxable payroll is projected to climb from 10.4 percent to over 16.5 percent, primarily because of the increase in the number of beneficiaries per covered worker. These projections are based on the "intermediate" set of assumptions in the 1979 Annual Report of the Board of Trustees of the OASDI trust funds, and assume a continuance of the OASDI program as defined in current law.

What caveats can be stated when making long range demographic projections? Since the future cannot be predicted with a high degree of certainty, the actual experience will undoubtedly be somewhat different from the quoted estimates. The purpose of the estimates, however, is not to make guaranteed predictions of the future but to indicate how the OASDI program would operate under future demographic (and economic) conditions that can reasonably be expected to eventuate. Such estimates should be based on the most realistic assumptions that can be adopted at the time the projections are made. In view of the inherent uncertainty, however, alternative projections on the basis of different (but not unreasonable) assumptions should also be made to provide information on the sensitivity and possible range of variation associated with the projections.

The emphasis on the aged dependency ratio should not obscure an important fact: the total dependency ratio (defined as the population aged 65 and over plus the population under 20, divided by the population aged 20 to 64) is projected to decline for the next 30 years and is not expected to reach its current level again until about the year 2020. The costs of supporting the retired population may be offset to some degree by lower child-dependency costs. However, direct or indirect transfer of revenue from child-dependency financing mechanisms (primarily private spending and State and local taxes) to the Social Security trust funds would require substantial changes in our social, economic, and political systems.

DEMOGRAPHIC TRENDS

Life expectancy--Mortality rates in the United States have shown a somewhat unsteady but persistent tendency to decline. Decreases in mortality generally result in an increasing aged dependency ratio. Mortality improvements at ages 20 to 64 (where average rates are already quite low) do not greatly increase the total number of such persons. Mortality over age 65 is much higher and any decline here results in a substantially greater aged population. The combined effect of lower mortality, then, is that the aged dependency ratio (and, consequently, OASDI expenditures as a percentage of taxable payroll) will increase significantly, as indicated below.

Fertility--Fertility patterns have different cost effects at different times. The fertility level in any year affects the number of workers 20 to 65 years later and the number of retired workers 65 and more years later. Therefore, the fertility level in any year affects the amount of income 20 to 65 years later and the amount of outgo 65 and more years later.

The post-World War II "baby boom" results in relatively high numbers of workers and amounts of tax income between now and about 2005, after which it results in relatively high numbers of beneficiaries and amounts of outgo. The low fertility of the late 1960's and 1970's, and expected low future fertility, result in relatively low numbers of workers and amounts of income in the early 21st century, just when the number of beneficiaries and amount of outgo is high.

Migration--Most migration is by persons of working age or younger, so that if net immigration occurs, aged dependency ratios will be lowered, at least temporarily. Net immigration into the United States has not been a significant factor in this regard since before World War I but conceivably could become an important source of future workers if the current low birth rates continue for an extended period.

Disability incidence--From the beginning of the U.S. Disability Insurance program in 1957 incidence rates have been increasing and it was not until recently that they began to level off and to decline. In the past 2 years, a substantial decrease has occurred. This variation is not readily explainable but is thought to be related to a number of factors including economic conditions, benefit levels, and program administration. As the prime determinant of the size of the disabled population relative to the active working population, incidence rates have a direct effect on disability insurance costs as a percentage of taxable payroll.

Female labor force participation--At the same time that fertility rates have been declining, greater numbers of women have been both entering the labor force and participating over a longer length of time. This has added an element of growth to the working population that will not be reflected in the number of beneficiaries for many years. Under the current Social Security program, the taxpaying participation of many women may result in only moderate increases in their future benefits; thus social insurance costs are reduced in proportion to the extent of female labor force participation.

Retirement Age--In the past decade, there has been a substantial trend toward earlier retirement. By 1977, 51% of all male insured workers age 62-64 and 57% of all such women were Social Security OASDI beneficiaries. Little evidence exists currently that this trend will reverse in the near future (although inflation expectations may tend to have this effect). In the future as health and life expectancy improve and as growth in the labor force slows, older workers may have the ability, opportunity, and incentives to remain in the workforce for longer periods. Social Security costs as a percentage of taxable payroll would be reduced in proportion to such extended worklives. Further liberalizations in the retirement test and/or the delayed retirement credit, however, would eliminate any program savings from later retirement.

Legislated higher minimum allowable retirement ages, after the turn of the century, may be more practical as a result of future demographic change, but would require substantial advance notice to participants, and revised socioeconomic expectations concerning work and leisure.

IMPLICATIONS FOR SOCIAL SECURITY POLICY AND DEVELOPMENT

One obvious result of demographic change is that a program enacted many years ago may not be appropriate for the needs of the changed society. The current benefit structure, which was based on typical pre-World War II family units with working husband, dependent wife, and several children, may no longer be the best choice in view of today's multiple-worker families, few children, and so on. Current and future Social Security development will need to reflect such changes if the program is to meet the income security needs of the population in an equitable and rational manner. The recent report of the HEW study group ("Social Security and the Changing Roles of Men and Women", February 1979) suggested several methods for restructuring the Social Security program so it might more equitably reflect the higher work force participation rate of women and the higher divorce rate.

The overriding influence on future Social Security development will be the financial requirements resulting from the aging of the population. Past

mortality and fertility trends and their expected continuation will place much greater demands on the productive sector of the economy in order to support social insurance programs as they are currently defined. In recent years, few program modifications resulting in higher benefits have received serious attention in Congress. Many cost-saving provisions have been considered, and some have been enacted.

CONCLUSION

In the United States, Social Security policy and development have traditionally resulted from the collective desire of the population for reliable protection against the potential loss of their ability to earn a living. The need for income security is unlikely to diminish in the future. Difficult decisions will need to be made regarding how best to provide a reasonable level of protection against specified contingencies at a price that the Nation can afford.

With sound knowledge and understanding of the current program, the public could decide on an informed, rational basis that the present program is satisfactory (and therefore worth supporting) or that particular changes are desirable to make the program more responsive to perceived needs but at a cost that is considered to be affordable.

Even with improved understanding, public agreement on Social Security goals may be difficult to achieve. The "numerator and denominator" of the aged dependency ratio have basically different concerns. The aged population naturally prefers benefit improvements while the working population would favor lower taxes. With the coming growth in the aged population, and with the older population's generally higher level of political awareness and participation, the potential for intergenerational conflict is very real and puts a further burden on all of us to help develop a system that is acceptable to participants at all stages in life.

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MR. DAVID A. RICCI: As a representative of a moderately sized home service insurance organization, the major thrust of my comments will be directed toward environmental changes as they affect the development of products relating to the middle income, primarily blue collar, market.

The reentry of our organization into the tax qualified IRA market with a flexible premium annuity product is a manifestation of federal pressures designed to produce changes in design and marketing methods that more closely reflect what is perceived to be the changing needs of the consumer. The general problem with compliance is that the sophistication and training of the distribution system and the market which it serves are at variance with the goals required by the regulatory agencies. That is to say, the susceptibility of fund transfer between one annuity product form and another based on very specific items relating to interest credit while ignoring both insurance values and the accumulation of previous funds, produced mostly by both competitive and regulatory pressures, will act to produce a greater loss of value to the policyholder, a loss in profitability of the product, and eventually a detrimental effect to the industry as a whole. To maintain a viable system in terms of tax favored individual products, those favorable insurance elements inherent in the policy structure must be stressed and service must be performed on a consistent basis. To

this extent, the home service organization may have a considerable degree of advantage over the Brokerage or General Agency System.

While the risk of investment loss is particularly severe in this area, the opportunity of earnings stability from the qualified product, and their ability to act as a buffer from more unstable product activity is reason enough to pursue aggressively the maintenance of an active market position in this area. In the early seventies, the position of our company with respect to interest adjusted cost measurements was such that we established a split interest cash value scale grading to net level premium which somewhat artificially produced indices which were quite competitive in the non-participating arena. Now it appears that subsequent pressures from the NAIC in terms of a payment index, the FTC in the terms of equivalent earning rates during the early durations, and particularly what we feel to be the increased awareness of these situations by the market,have led us to reconsider our position in terms of value offered and to seek the development of permanent plans which embody minimum values and very competitive premium rates on a non-participating basis. Similar environmental factors have caused us to reconsider our competitive position in the term arena and also establish an agency compensation agreement, which allows for equivalent value on the sale of term products. However, we feel, along with the ACLI, that industry has a responsibility to promote the appropriate view of permanent life insurance vehicles in the face of the FTC report.

A much more substantive and realistic threat in the area of consumerism to home service industry is the relationship of the frequency of premiums charged to the collection service. Agency organizations simply are not performing the collection function in the manner similar to that employed a decade ago. The answer is a much more equivalent compensation system which relates equitably modal premium assessments to additional service provided. Any method developed should also be responsive to changes in service.

The imposition of the Flesch Test, its acceptance by the NAIC and incorporation in several State laws has led our organization to restate all policy forms in "simplified language". Just how far this trend will go is unsure at the moment, but the implications on decisions relating to interpretation on a legal basis may be far reaching, particularly in areas of specialized coverage, such as accidental death, disability income, and dread disease coverage.

We have viewed with much interest the attempt of certain members of the industry to address changing economic and social values of the consumer with some form of an adjustable life product. We have also noted the decline of such interest in recent months and intend to enter the market in a modest phased basis with an initial offering of the guaranteed insurability rider based on cost of living increases, coupled later with an adjustable term, and hopefully following with the modification of a premium deposit fund which allows for the purchase of additional insurance in future years. The critical factor in this area is the ability of our systems to address the continuing needs of the policyholder. Our distribution system is uniquely qualified for approaching this particular situation. However, it remains to be seen whether our type of agency force can develop the necessary sophistication to address the flexible needs of the changing family. Our best guess is that a modest version of adjustable life will be a very viable part of our company's future.

In the limited market in which we operate, the effect of an ever increasing portion of retirement income provisions being supplied through governmental means has created a more competitive framework within the pension area. To this effect, we have consistently established more liberalized approaches to underwriting within the pension area in order to capture a healthy share of that market. The wisdom of continued liberalization in this area is severely in question. I believe the individual product funding vehicle for pension plans is slowly dying as a marketable alternative for our type of organization.

Our marketing efforts have consistently been directed toward a male dominated work force which was composed primarily of individuals between 18 and 30. The effect of the changing age-sex composition of this group has caused our organization to severely scrutinize the method in which we market our product. We feel that as the average age of the work force becomes more mature, so also do the security needs and attitude of the potential insurance buyer. Contingent terms, adjustable life, and more flexible benefit products are the long term answer to changing market distribution and needs. The home service area must have the ability to mature and respond as its market also changes, particularly with respect to the way in which premiums are collected and the overall service aspect. Our decision to leave the industrial life area and attempt to answer the conversion needs of these policyholders is one manifestation of our feeling that the organization must change to be more responsive.

There is no doubt that the problem of inflation has affected all organizations which rely upon permanent non-participating insurance vehicles as their primary market thrust. Continued inflationary impact of 5 to 6% for a prolonged period may act to make the sale of flat benefit permanent life a thing of the past.

The problem of inflation as it changes individual security needs,if not continuous, will have to be addressed for the foreseeable future. One such answer from a product development standpoint is the creation of semi or fully adjustable life products as alluded to above. The key issue is that we as insurers will not survive if we do not recognize that changing financial conditions will produce fluctuation in income needs that must be addressed in an insurance program. We all are familiar with the effect of 20 years of inflation upon living values, as any immediate retrospective will verify. The key problem here is one of education, not only of the agency force but also of the policyholder at solicitation.

There are also a number of other major environmental factors which have a bearing upon individual security provisions. One is that major advances in technology will allow us to be much more responsive to individual needs as they change through environmental influence. The phase in which hardware has been used as a personnel replacement vehicle is just about over. The next phase will be one in which the expanded machine capabilities will allow us to alter our distribution methods and capacity.

The impact of mortality and morbidity trends is hard to judge at the present time. I believe that within the next 20 years there is a reasonable chance for shift in middle age mortality rates, in which essentially the major cause of the death will be attributable to accidental means only, much in the same manner as juvenile mortality rates today. It will be a much more difficult task for us as insurers to sell life insurance as a risk avoidance mechanism.

As the family unit becomes smaller and the attitudes of society shift toward a more individualist framework, as they have done in the past decade, there will be extreme pressure particularly in the market in which we currently operate to simplify overall underwriting rules in order to make the procurement of insurance a much more palatable function. We see in this a great future in the salary deduction and general allotment market areas. The insured will expect to be serviced in such a way as there is very little initiative expected on his part.

It is indeed a great challenge for the entire insurance industry to react to the very fast-changing environmental influences. It is obvious that the response cannot be complete, but we must adopt a posture of willingness to understand the forces at work, and determine the best means in which we can not only survive as an institution with these forces, but also use the changes as an opportunity for substantial growth.

MR. ROBERT J. DYMOWSKI: My remarks will address several of the points mentioned on our agenda: inflation, regulation, consumerism, taxation, and the changing age-sex distribution of the labor force. There are undoubtedly other factors likely to have an impact on group benefit programs and I hope my comments will be helpful in forming your own thoughts on this topic.

Inflation--I consider inflation to be a major force with which employee benefits must contend, both now and in the future. I believe that the effects of inflation affect several of the above factors and present a challenge to actuaries involved in the development, pricing, and provision of Group benefits. While this applies most particularly for medical care benefits, other Group benefits are also affected.

The peaks and valleys of recent inflation rates have brought us to a point where 5% to 6% now seems to be the minimum level of built-in inflation which is generally considered likely over the near future. Medical care represents the major element in Group employee benefits. The medical care portion of the CPI has generally exceeded the CPI for the past twenty years (except for the Federal control period in 1973-1974 and currently). This portion of the CPI appears to have moved to a higher plateau than the overall CPI, and an underlying rate of 9% or more seems likely--producing a doubling of medical care costs in about eight years.

Historically, the achievement of such plateaus has been caused by a period of recession or depression. The economy appears to be moving in this direction now, and this could produce increased utilization of group benefits, particularly medical care and disability income.

Group insurance benefits represent a major piece of an employee's compensation package. Once benefits have been established, employees are reluctant to lose them, or have them decreased. Thus employers recognize these benefits as a significant and largely unavoidable cost of doing business.

Inflation in both the general economy and in the medical care sector have become an item of major concern to employers and employees alike. Employers seek to avoid the risk of catastrophic medical costs associated with inflation and rapid increases in medical care technology through medical care coverage. The risks of loss of income due to disability or death of an employee are similarly provided for by disability income and life insurance benefits.

With the costs of other necessities increasing so rapidly, the individual employee is not likely to be willing to accept greater responsibility for his own benefit costs, and is likely to want to avoid risk by obtaining even more coverage. These attitudes influence consumer activities, cause mandated benefit extensions, and may be reflected in a desire to retain coverage by staying in the work force longer. This attitude about personal responsibility was described as the "psychology of entitlement" in the Rappaport - Plumley paper presented at the 1978 Annual Meeting (TSA XXX, p. 245).

Of course, these employee desires increase the cost pressure on employers. The availability of comparable benefits from a variety of carriers has created a buyer's market for employers wanting to purchase benefits at as low a cost as possible. Larger groups have turned to non-insured programs or other special rating arrangements as a means of cost savings. Their objectives have been to save premium taxes or risk charges and to have an opportunity for additional investment income on the cash flow represented by claim reserves. Unfortunately, many groups make such changes in their benefit programs without understanding the risks associated with them. This is because they consider the first-dollar coverages normally provided by insurers as very predictable. Most carriers have responded to this market with programs in which the group retains most of the risk but obtains stop-loss coverage for protection against severe losses.

The movement away from the front end of such risks, that is the higher frequency, lower average claim portions, can probably be seen as desirable by most actuaries. It recognizes the conventional wisdom long maintained by brokers or agents that large groups will eventually pay for all of their own claims and expenses under any experience rating arrangement. This assertion is true only to the degree that carriers are able to recoup deficits from groups with poor experience.

A problem associated with this movement back toward the tail of the risk is the potential volatility of such risks, and the surplus required to support them. In this connection, one aspect of inflation which should be noted is the leveraging effect of high deductibles. For example, an underlying annual trend of 14% for medical care at the $0 deductible, 100% benefit level corresponds to a trend of 20% at the $1,500 deductible level and almost 28% at the $5,000 deductible level. Programs in which employers bear the risk of the first $1,500 or so of benefits and insure the excess are being fairly widely sold, particularly for smaller sizes of groups which might not otherwise consider a self-insured arrangement. I question whether groups purchasing such coverage understand this, and whether they will accept renewal increases reflecting such assumptions.

Diminishing the premium base of carriers due to their acceptance of lesser degrees of risk means that it will be more difficult to develop and retain surplus for the remaining risks, although available surplus may provide a greater degree of protection to the remaining volume. The greater potential for volatility associated with group products involving low frequencies and high amounts means that adequate surplus must be maintained. A lack of surplus can also lead to a problem in providing coverage on smaller groups on a traditional insured basis.

A question which actuaries have long considered, and which appears to be receiving a good deal of interest currently, is that of the level of surplus needed to adequately provide for the risks undertaken by an insurer. I

recently read an interesting paper in The ASTIN Bulletin for March, 1979, (Vol. 10., Part 2) by G. C. Taylor entitled "Probability of Ruin Under Inflationary Conditions or Under Experience Rating". This paper studies the effect of inflation,of premium income and claims size distributions,but not of free reserves or surplus. It shows that the probability of ruin is always increased when the constant inflation rate assumed is increased. It also shows that ruin is certain, irrespective of the rate of inflation, the largeness of free reserves, and the safety margins in premium,if inflation occurs at a constant rate. It also demonstrates that the corresponding eventual result for an experience rating system is certain ruin. I recommend this interesting paper to you, and suggest that we should all evaluate its findings very carefully in the light of current economic conditions.

The problem of maintaining an adequate level of surplus under inflationary conditions can be demonstrated very easily. Consider a company with a group insurance portfolio as follows:

	Percent of Premium Income in 1978
Group Life and AD&D	15%
Disability Income	10
Medical Care	75
	100%

Further assuming:

(1) Group surplus at 12/31/78 = 20% x (1978 Earned Premium)
(2) Net growth excluding premium increases = 10%
(3) Premium increases (rate and benefit changes):

Life, AD&D	3%
Disability Income	5%
Medical Care	14%

(4) A surplus contribution of 2% of earned premium resulting from net operating results.

This produces a surplus level at 12/31/79 of only 18.3% of 1979 earned premiums. Repeating these assumptions for another year would produce a surplus level at 12/31/80 of only 16.9% of 1980 earned premiums. This would represent a reduction of almost 15% in the degree of protection afforded by the company's surplus level over the two years, and would be cause for concern if the original level of 20% had been considered necessary to provide adequately for the contingencies faced by the Group operations. Lacking an ability to control the effects of inflation on premium and claim levels, a company's only means of maintaining a surplus level which it considered appropriate would be to limit its growth significantly, to reduce its exposure to risk, or to increase contributions to surplus. I am aware of one major group carrier which has indicated that its interest in writing A.S.O. business was a direct result of its concern for being able to maintain an adequate level of surplus. If carriers begin to be unwilling to accept risks because of a lack of capacity, it seems reasonable to assume that those wishing to transfer the risks will increase pressure on the Federal government to do so through NHI or similar programs.

Regulation--Group life or disability income benefits are generally revised in relation to the economy. The rapid increases in cost and improvements in technology in recent years have caused considerable upgrading of medical care benefits. In addition to such changes, another force for change in benefits has been regulation at both the state and Federal level.

In many states various types of mandatory benefits have been introduced into group insurance contracts in recent years. These have included required benefits for newborn coverage, psychiatric inpatient or outpatient coverage, conversion privileges and improvements in the coverage for special conditions such as alcoholism or drug addiction. Generally, the interest of the regulatory authorities mandating these benefits has been to address "deficiencies" in benefit programs. In many cases, these "deficiencies" were actually underwriting controls which had been included in the original contracts because of either the unknown nature of the risk involved or the susceptibility of such risks to selection against the group insurance program. Thus they enabled underwriters to provide broad categories of coverage at reasonable and competitive rates. The net result in most cases of mandated benefits has been an overall increase in the cost of employee benefit programs.

Two significant examples of recent changes in benefit requirements are the mandatory maternity benefits required under provisions of the Equal Employment Opportunity Act, and in the effect on benefits for older employees of the Age Discrimination in Employment Act.

Consider the general treatment of maternity benefits in group health contracts:

(1) They are generally not as rich as other benefits in the package, requiring greater direct participation in costs by the insured.
(2) Only complications are usually covered under Major Medical.
(3) A nine-month waiting period and a corresponding deferred maternity benefit period are normally applicable.

The philosophy underlying this benefit design recognizes that maternity differs from other disabilities in the degree of control of it by the insureds. Thus it has been assumed that such expenses can be budgeted in advance and need not be insured in full.

Now, however, the average maternity cost per case of about $1,800 has combined with factors such as women's rights and the percentage of working women to create pressure to provide this benefit on the same basis as any other disability. The result was the amendment to the Equal Employment Opportunity Act effective as of May 1, 1979. The net result of this amendment is that there is to be no difference between the treatment of the benefits required due to maternity or any other disability under employee benefit programs. This applies to both medical care benefits and loss of time programs, for groups with fifteen employees or more.

The responsibility for the requirements of the act rests with the individual employers and not with the carriers providing the benefits. Obviously, in order to provide satisfactory service to their policyholders, it has been necessary for carriers to revise contracts and develop necessary rate adjustments to these benefit programs to reflect the requirements of the law.

Depending on the exact age and sex distribution of a group of employees, the increase in medical care costs due to improving maternity benefits to the same basis as all other benefits can vary significantly from group to group.

An example of the lack of appreciation of the intention of benefit design for maternity was shown by the initial interpretation by the E.E.O.C. of the impact of the amendment on the usual provision of extended benefits for maternity. This arrangement was intended to provide a consistency of treatment for maternity claims with other claims, with the basic idea being that coverage would be provided for the claims incurred in a specific period for which premium was actually earned. The nature of the extended benefit provisions differed between maternity and non-maternity benefits because of the lack of a similar period between the inception of non-maternity claims and the services provided for them as opposed to the normal period of pregnancy. In its interpretation of the amendment the E.E.O.C. indicated that:

(1) the extended benefit provisions associated with maternity could not be reduced to be consistent with non-maternity benefits,
(2) the extended benefit provisions for all other disabilities must be consistent with the maternity provisions, and
(3) the initial waiting period for maternity could not be any longer than the waiting period for all other benefits.

Thus a greater exposure to the group for all benefits than otherwise had existed before the amendment was produced. Fortunately, in September the E.E.O.C. changed its position to no longer make this interpretation, which had been called "an outrageous distortion of Congressional intent" by Senator Richard Schweiker (R-PA).

The required changes to group programs because of the Age Discrimination in Employment Act are a reflection of economic conditions and a natural outgrowth of the change in attitudes of the work force. The pressure of inflation is causing more individuals to seek to continue employment beyond normal retirement. Group life benefits have customarily provided for reductions in benefits due to the attainment of age 65 with the intention of avoiding selection by individuals insured for large amounts. These reductions were normally a specific cutback at age 65, such as 50%, with a grading down of the benefit to zero at age 70. In the case of medical care coverage, the assumption was made that individuals would normally become covered by Medicare and their group benefits were either completely eliminated or continued through some Medicare supplement. The provisions of the act require that any reduction in benefits due to the attainment of specific ages be actuarially justified based on expected increases in costs at those ages. The objective of the provision is that active employees aged 65-70 should be treated on the same basis as all other employees.

I suggest that several conclusions or implications can be drawn from such regulatory actions:

(1) Inflation has been a contributory factor in bringing them about -- by causing more women to join the work force on a long-term basis and by causing individuals to seek to continue working beyond age 65.
(2) They will contribute to further inflation by increasing the costs of employee benefit programs through either insured or uninsured benefits, and resulting in these cost increases ultimately being passed along to consumers.
(3) They may lead to further extensions of benefits -- to non-traditional

households, to retired and terminated employees, or for currently limited benefit categories.

(4) They may be developed by individuals who have little understanding of the reasons for the original restrictions or the degree of risk represented by such changes in benefit structures.

Consumerism--I believe that many of the attitudes which are expressed as part of the consumerist movement are closely related to the "psychology of entitlement" mentioned above. Thus, it seems likely that this movement will cause demand for additional services to be provided on a group insurance basis wherever possible. A major element of consumerism is the emphasis on obtaining products at the lowest possible cost to the consumer. Because of the ability of the group benefit vehicle to provide products on this basis, it seems likely to be viewed as a desirable means of providing benefits while avoiding the acquisition costs associated with individual life and health insurance.

In response to consumerism, group carriers must give increasing concern to revising their contracts to improve readability. This has become a common requirement of insurance departments and can represent a significant expenditure of time and effort. I believe that consumerism will also require companies to improve services to their insureds in as many ways as possible, particularly as related to billing and claim administration practices. In order to offset the increase in operating expense required by such services companies are turning even more to the use of computers for many aspects of group operations. It seems likely that only companies which are successful in keeping expenses at minimum levels through their use of computers and standardized processing systems will be successful in competing for the benefit programs of major groups and remaining competitive in the smaller group market.

One aspect of consumerism seems to be a distrust of corporations and their profit objectives. In their emphasis on the benefits and services being provided, activists in the consumer movement often fail to appreciate the risks associated with the provision of benefits. It is the acceptance of these risks that justifies the profit objectives of the insurers, and this must be communicated effectively to consumer advocates or regulators influenced by them.

Perhaps partially in response to these attitudes and also as an outgrowth of the increasing interest in ASO arrangements discussed above, more third-party administrators or organizations intended specifically for claim payments have begun to compete with carriers for the payment of claims on non-insured programs. Because such organizations exist specifically for claim payment functions they may often operate with a lower overhead than the insurance carrier and can therefore offer very favorable retention charges for their services. In order to retain such business, carriers will need to demonstrate that their experience in the areas of claim control, utilization review, and overall efficiency in service can result in a more cost-effective program in the long run.

Taxation--Group employee benefits have enjoyed a favorable tax status. Except for life insurance benefits in excess of $50,000 per year, these benefits do not constitute taxable income to employees. This has undoubtedly contributed to their growth as part of the bargaining process between labor and management. It has also been questioned as a possible contributing factor to the inflation in medical care costs.

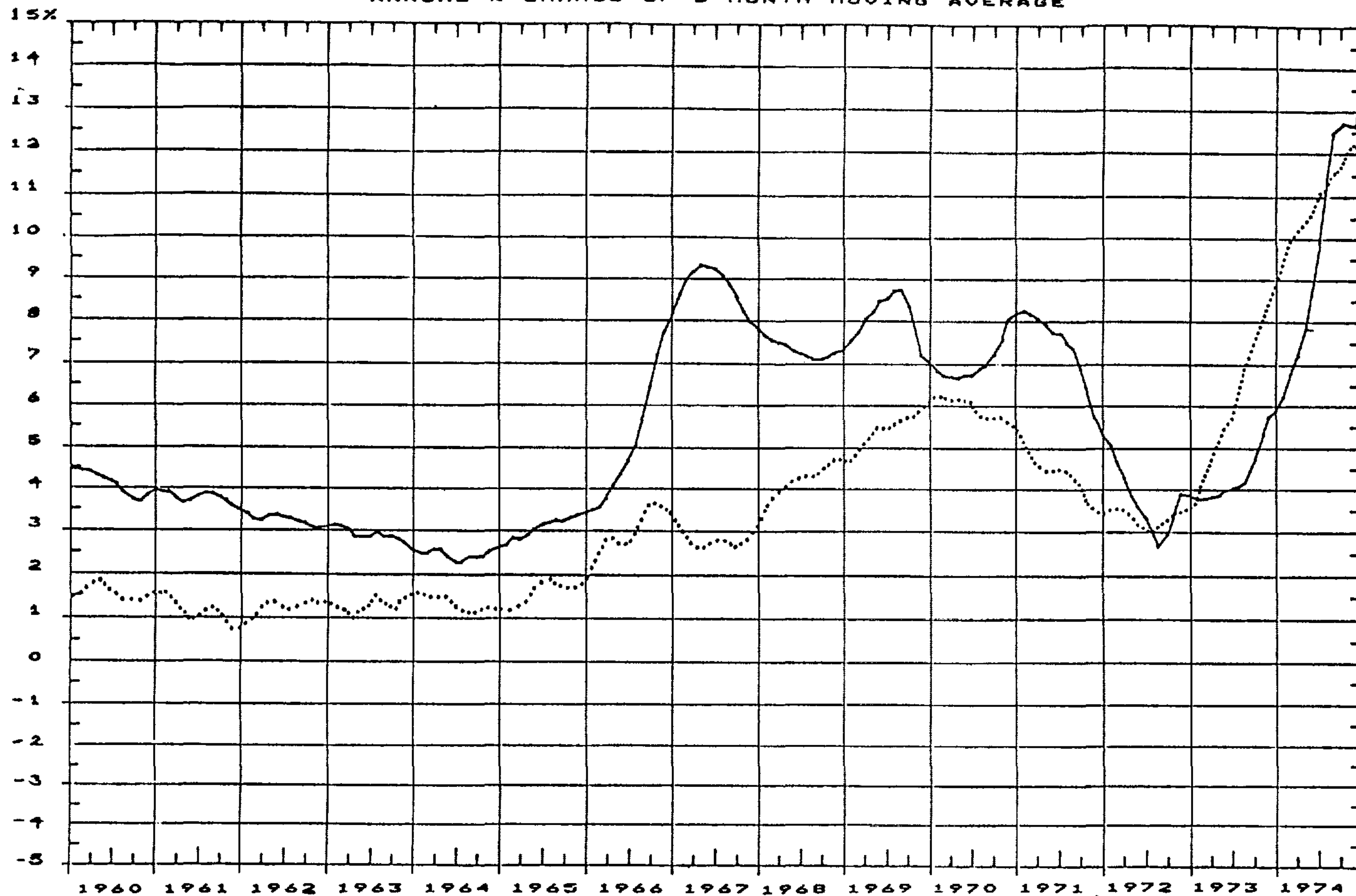
While I have not yet been able to read a transcript of the hearings, a Congressional Oversight Subcommittee concerning Medical Tax Expenditures recently met to consider whether the present tax-exempt status of employer contributions to employee benefit programs should be revised. Since employee benefits are such an important part of the compensation package it seems unlikely that making such contributions taxable income to employees would have any major effect on the provision of such benefits. It does seem possible that alternate funding arrangements might be pursued, however. Specifically, if premiums became taxable income to employees, employers might be willing to consider various selfinsured arrangements if the same benefits could be provided to employees without increasing their taxable compensation. This could lend to a further deterioration in the risk-taking capacity of insurers as discussed above.

Another aspect of taxation which may be of increasing interest to group employee benefits is whether states will begin to attempt to collect some form of tax on benefit payments in lieu of premium taxes. Since relief from state premium taxes is one of the major considerations of groups in considering alternate financial arrangements the application of some tax to the benefit payments made under such programs might serve to reduce significantly the incentive for employers to explore their feasibility. This would, of course, be likely to be only one aspect of such decisions, since the primary decision should be the willingness of the group to be exposed to the potential risks associated with its benefit program through such financial arrangements.

Age and Sex Characteristics of the Labor Force--The composition of the labor force has changed very dramatically over the past twenty years. It has moved from a split of approximately 68% male, 32% female in 1960 to a distribution of approximately 60% male and 40% female in 1977. While the total labor force increased by about 38% over this period of time, the female participation in the labor force increased from 23.2 million to 40.1 million, or approximately 73%.

This shifting in the labor force has naturally been most pronounced at the younger ages, with the under 35 age group moving from 39% of the total in 1960 to 50% of the total in 1977. Surprisingly, the portion of the labor force represented by individuals aged 55 and older declines only from about 18% to about 14% over this period. Recent concern over the effects of inflation and the removal of mandatory retirement ages is likely to combine to increase the participation of such individuals in the labor force in the future.

A primary item of significance to group employee benefits related to this shifting in exposure has been the need to reevaluate traditional underwriting practices regarding eligibility and participation requirements. This has been true especially because of the entry into the labor force of a greater proportion of married women , producing a greater number of individuals eligible for insurance coverage both as employees and as dependents. Companies have therefore found it necessary to relax participation requirements where eligible employees elect not to participate in coverage because of the presence of other insurance benefits. The increasing tendency for participation in the labor force on a part time basis may also result in reconsideration of the definition of eligible employees for benefit purposes, or development of special benefits for such employees.


MEDICAL CARE SERVICES (CPI)
ALL ITEMS (CPI)
ANNUAL % CHANGE OF 3-MONTH MOVING AVERAGE
15%
14
13
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6
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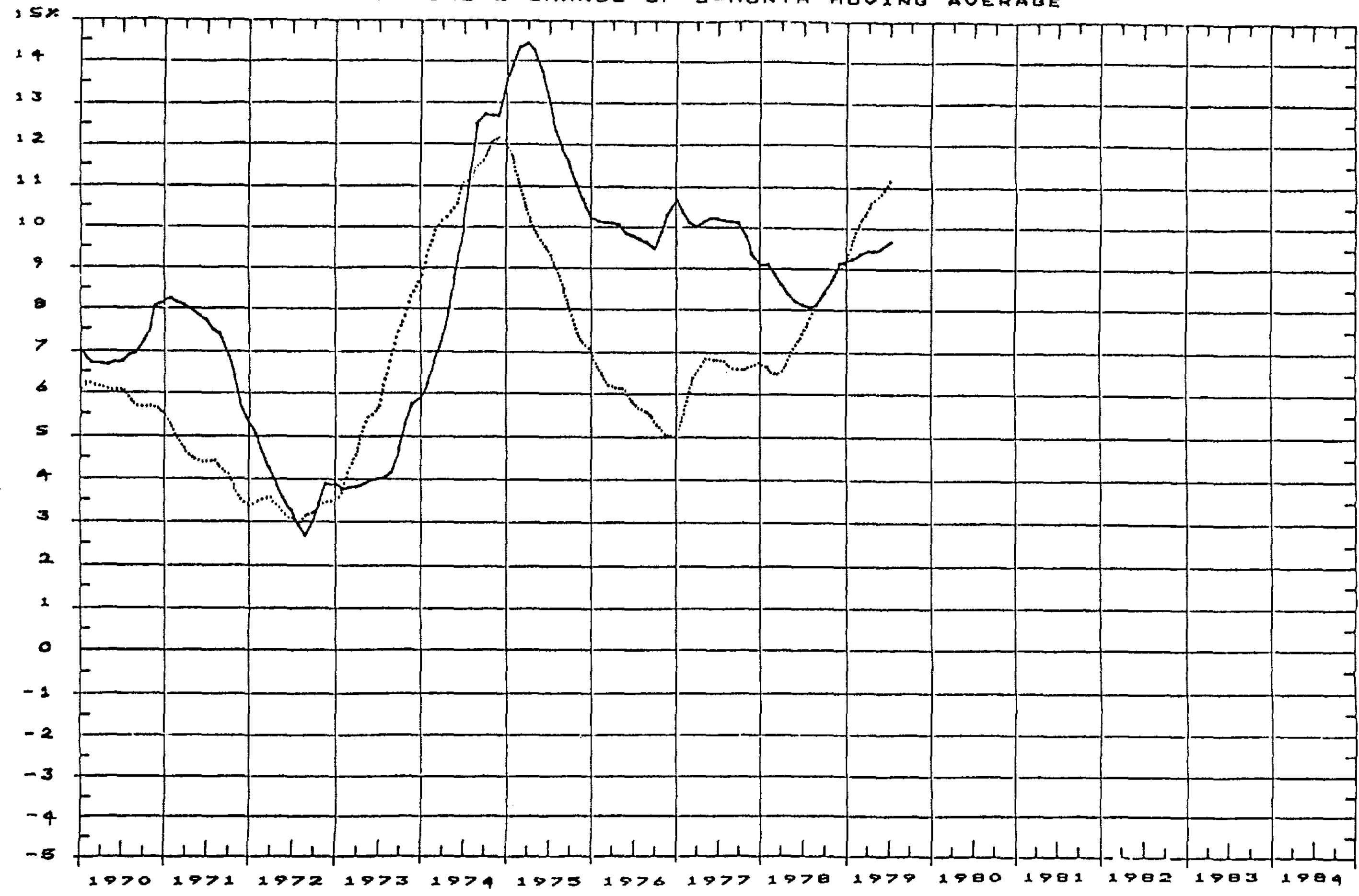
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1984

XYZ COMPANY
GROUP SURPLUS LEVELS

ASSUMPTIONS

1. 1978 Group Premium Income Distribution:

Life, AD&D	15%
Disability Income	10
Medical Care	75
	100%

2. Group Surplus at 12/31/78 of 20% of 1978 Group Premium Income

3. Annual net growth excluding premium increases of 10%

4. Average annual premium increases (rate and benefit changes):

Life, AD&D	3%
Disabiility Income	5
Medical Care	14

5. Annual surplus contribution of 2% of earned premium

GROUP SURPLUS AS % OF PREMIUM INCOME

12/31/78	20.0%
12/31/79	18.3
12/31/80	16.9

* * * * *

LABOR FORCE DISTRIBUTION*

	1960	1965	1970	1977
MALES				
Age Group:				
Up to 34	26.3%	26.4%	27.6%	29.6%
35 - 54	29.1	28.1	24.7	21.3
55 and over	12.1	11.5	10.8	8.8
Total	67.5%	66.0%	63.1%	59.7%
FEMALES				
Age Group:				
Up to 34	12.3%	13.2%	16.1%	20.9%
35 - 54	14.6	14.8	14.6	13.9
55 and over	5.6	6.0	6.2	5.5
Total	32.5%	34.0%	36.9%	40.3%

*Source: 1978 Statistical Abstract of the United States

MR. HARRISON GIVENS, JR.: Introduction--The general theme of this Concurrent Session is the impact of a changing environment on personal security programs. And indeed the environment is changing -- rapidly, boldly, unpredictably. It is not only desirable that you think of these changes and their impacts on your work, it is essential if you are not to lose your professional perspective and become just another twig swept along in the growing torrent of change. To understand is the necessary prelude to influencing these changes wisely.

My own part of this general theme is to consider group mechanisms for personal security, but I will also touch upon individual programs as they are affected by general principles.

Changing Times--Is it really necessary to prove to you that long-standing values and perceptions in our own fields of work are greatly changing? As one example, consider Social Security. Even five years ago it had still its marvelous public image of a mighty, growing engine of economic security and social justice. In these last few years, however, the perception has developed that it may not be prudent, or even possible, to provide adequate retirement income through Social Security alone. Where now is the self-confident assertiveness of the "expansionists" that Bob Myers contended with so hard in the 1950's and 1960's? Indeed, the passage of ERISA in 1974 marks a watershed - this legislation clearly picks up the private pension plan universe, scrubs it, sanitizes it, straitjackets it, and adopts it as an instrument of public policy. Henceforth, national policy is to assure the preservation and spread of private pension plans.

As a second, and more current example, consider tax policy. We are now moving into some form of recession. Ever since the Full Employment Act of 1946 we have known what to do - spend our way out of it. This accounts for our marvelous success in the past thirty years in avoiding recessions, stock market disasters, and the like. A central part of any program to increase consumption in troubled times is, of course, the tax cut. None of you is surprised, therefore, to see that a tax cut for 1980 is widely discussed now, and -- in one form or another -- as much of a sure thing as anything political can ever be.

But what form? President Carter likes the idea of cutting back on Social Security taxes. That will put money largely into the hands of the lower paid, who can be counted on to spend it, and thereby support higher consumption. But the extraordinary news is that a quite different route is being explored enthusiastically by a Congress suddenly concerned with lagging productivity and capital investment. This "new wave" of thought is strongly drawn to allowing deductions from taxable income for employee contributions to personal security programs. We have had HR 10 programs for the self-employed for 15 years, and IRA's for regular employees for five years, and now we would allow deductions even for the somewhat more than half of the work force covered by private plans. Hence the idea is not brand new, but the motivation is dazzling -- let's have a tax cut that does not stimulate consumption but that does add to capital formation. What a breath of fresh air!

The President's Commission--Other examples could be cited of the currents of change, but let us consider only the most obvious candidate -- the natural focus of all current re-examination of retirement income programs. This is, of course, the President's Commission on Pension Policy. Conceivably, the work of this Commission will come to naught. Don't count on it -- remember

the President's Commission appointed in 1963 by Kennedy, which reported in 1965 to Johnson: it drew up the specs for the ERISA that came nine years later. This time the gestation period will not be so long.

If the current Commission had been created several years ago -- before the growing awareness that Social Security has substantial constraints on its ability to do the whole job, before any appreciation of the essential role of private plans in capital formation -- I would have been highly apprehensive. Indeed, the Commission's staff seem to be remarkably free of awareness of these currents of change. Happily -- for us, and for the country -- the Commission seems quite open to information, quite concerned to produce a sound, valuable report that truly will make a difference. And so I come to my "commercial", and the main thrust of these remarks. Please -- for your sake, for mine, for the country's sake -- pay attention to the efforts of this Commission. Follow its announced agenda. Think -- and think hard -- about the work it is doing. Help it -- with timely presentations of information, reasoning, advice. Be thoughtful, be clear -- they are not all pension experts -- be conceptual, be timely. The window of opportunity is open. Speak up before it closes, lest your fate, and in good measure the nation's fate, be settled by others.

Starting Afresh--Shall I set an example? Let me ask you how this country should look now to public and private programs for retirement income if no such programs existed. Start afresh. Is it likely that the Social Security program we know today -- born of the deepest insecurities of the 1930's, expanded ambitiously in the 1950's and 1960's -- would be what we would want to create for the first time in the 1980's? Would we still choose to place primary emphasis in the private sector on employer decisions, and little or no emphasis on the role of the individuals for whom all this machinery is to be erected? I doubt it.

Well, then, what would we draw up if we could start afresh? It is a valid, even fundamental question, even though, of course, we are not starting afresh, because if we know where we want to go we can get there. I will offer you one possible arrangement, but first I want to identify some issues, and in the process challenge our standard assumptions, and loosen up your thinking.

I. In the area of Social Security, there are fundamental issues to be addressed:

1. What does "floor of protection" really mean? Can it possibly include $9,000 per year of tax-free income for a 1979 retirement?
2. Is the present law free of sex bias? Should it be?
3. Is there still a role for substantial dependents' benefits, or should these be curtailed or eliminated?
4. Are we satisfied with the nature and level of death and disability benefits?
5. Why couldn't Social Security have more pre-funding, using, e.g., blind trusts under private sector management to avoid political implications?
6. Why should Social Security benefits be indexed to inflation automatically, when the active workers whose taxes fund such benefits have no such protection? Perhaps such indexing should wait until the nation gives up on controlling inflation and indexes the federal income tax brackets and issues indexed bonds.

7. Why should Social Security benefits be tax-free? Shouldn't half be taxable? Or allow current deduction of the employee's tax, and make benefits fully taxable?
8. What's wrong with some funding from general taxation, sales taxes, or VAT? In earlier days that would have allowed benefit expansion, but today there is no room for easy expansion of any program. And isn't there good reason to argue for the introduction of a national sales tax or VAT, provided the federal income tax rates are correspondingly dropped, in order to encourage earnings and capital formation and discourage consumption?

II. In the area of private pension plans, there are some important principles to re-examine:

1. In the absence of countervailing law (primarily ERISA), employers could arrange pension benefits to be highly discriminatory and drastically simplify reporting simply by going pay-as-you-go. The only tax incentive for private pension plans is the exemption of investment income on plan funds, and of course it is taxed to the beneficiaries later as benefits are paid. At the least we could demolish the "tax subsidy" illusion; we might even be able to allow employers to pay pensions on an informal basis, which is now illegal.
2. The rule for integration should be that the sum of private pensions and Social Security does not decrease with rising earnings as a percentage of gross pay. This is not a "protect your turf" proposal. It is a numerical demonstration based on a specific, conceptual approach. If you are interested, give me your card and I will send you a detailed exposition.

III. In the area of the individual's provision for his own future, there is now a bewildering array of different tax treatments to sweep away:

a) employee contributions to a corporate plan are not deductible, but
b) HR 10 contributions are deductible, and
c) IRA contributions are deductible, but with different limits, and
d) TSA contributions are deductible, but with still different limits, while
e) no man-in-the-street savings are deductible, but the interest build-up is taxed differently, depending on the instrument:

   i) annuities, or
   ii) savings accounts with current interest, or
   iii) savings accounts with interest penalties, or
   iv) E bonds with a choice of tax incidence.

An Illustrative Proposal--All right, enough questions. Here is a specific proposal. To be successful, I do not need it to persuade you, but only to stimulate you into developing your own ideas. Then let's let our differing ideas compete, and choose the best among all of them. I start with the following:

Premise: The scope of a national retirement policy is the partial replacement of income that ceases upon retirement. Hence the focus is on earnings, and the maintenance of living standards supported by those earnings, rather than any concept of "need", social assistance, or welfare.

I. Social Security

A. Should be universal.
B. Should be a flat $5,000 per year, but not to exceed 80% of average earnings in the ten years before retirement.
C. Should be proportionately less for those with less than career coverage, say 25 years.
D. Should not be increased because of dependents.
E. Should be fully taxable (hence the retirement test controversy is avoided), and employee taxes should be tax-deductible.
F. Should be available in full at any time after 65, i.e., no actuarial increase for late retirement.
G. Should be available with some reduction, say 4% per year, as early as age 60.
H. Should not be indexed.
I. Should be funded by a tax on employer and employee of 5% of the first $10,000 of annual earnings, plus -- when needed -- a national sales tax, labeled for Social Security, at a level varying from time to time so as to bring in an additional amount equal to cover projected income inadequacies of the next two years.
J. Should have no death or disability benefits in this program, although they could be provided in suitable form through an independent new program.

II. Individual Savings

A. Should be emphasized as the most important private supplement to Social Security.
B. Should allow tax-deductibility for everyone, regardless of employment status, up to 10% of the first $50,000 of earnings.
C. Should have no tax on investment income.
D. Should be taxed as regular income -- without penalty -- whenever withdrawn.

III. Employer Benefits

A. Should have present tax treatment if the plan meets simple qualification standards:

1. Numerical coverage test.
2. Integration permitted as long as employer benefits plus Social Security do not increase as a percentage of earnings as earnings rise.
3. Vesting as soon as the accrued benefit is $1,000 per year.

B. Should be allowed to go the pay-as-you-go route if there is no written announcement to employees. No special tax help means no qualification requirements, and no reporting.

The thrust of this proposal is to increase the role of personal (individual) security programs, support employer-sponsored programs, and restrain the overgrown Social Security program. This moves the emphasis to the parts of the three-legged stool that are able to develop investment capital and withstand the demographic changes ahead. And it preserves the voluntary character of personal security above the mandated minimum level -- society can afford to have grasshoppers as well as ants.

MR. ERNEST J. MOORHEAD: I have three questions. Dave, your company is slowly phasing out of the individual policy pension market. Do you consider this an industry-wide trend? Bob, you stated that consumer activists fail to appreciate that the acceptance of risks justifies the profit objectives of the insurers. Would you comment on the coexistence of mutual and trust companies as well as the role of the stockholder? Harrison, you appear to be predicting and advocating tax deductions for individual savings. Would you include premiums for whole life individual policies in your definition of savings?

MR. RICCI: My comments were based on my own company's experience and should not be appointed to the industry as a whole. Considering the degree of complexity in the current underwriting rules, the heightened consumer awareness, and the administrative complexities, my company feels that it is just not in a position to answer this type of market. There probably will be a concentration of insuring organizations that will be addressing the question much more accurately, redefining it, and taking a much larger portion of the market.

MR. DYMOWSKI: With regard to mutual vs. stock companies, in the context of group insurance benefits, stock companies are very competitive, particularly with large groups. Even though mutual companies do not deal with profits, they need to generate surplus in order to undertake risks. Stock companies generate profits which are intended to build up its surplus and its risk-taking capacity. So, I am not sure how I would differentiate between them in that sense.

MR. GIVENS: Certainly individual annuities ought to be deductible and, although it may be difficult to define, the permanent premium portion of a whole life policy, retirement income policy, or anything more than term ought to be deductible. Many interesting questions will arise about when is part of the premium for a whole life policy deductible for business use or estate planning.

MR. LAWRENCE N. MARGEL: Harrison, I can agree with most of your basic ideas. However, they seem to run counter to the general philosophy of the bureaucratic planners and administrators in Washington. These bureaucrats see inherent inequities in the general income distribution of the workforce which they try to rectify in the postretirement period. They, therefore, see little value in relying on private savings in delivering retirement income, since this just maintains the perceived inequity of the preretirement distribution of income. Since the implementation of your ideas would require such an abrupt change in the thinking of these bureaucrats, I am not at all optimistic that your ideas could come to pass. Do you have any comments on this?

MR. GIVENS: I would agree that the problem of getting anything like what I am suggesting is political, and the probability of getting it is low. However, even just a few years ago I saw no evidence of even a small bending toward different directions. Today I can point to the Proposition 13 reaction against big government and the awareness that throwing money into programs does not necessarily bring about change. For the first moment in our recent history, now may be the time when there is some hope for change by forcefully, conceptually struggling for the things we are talking about today, for individual solutions rather than national solutions. Let us get some good thinking into the political process, because, if we do not try, Larry, I can guarantee you that nothing will go through.

MR. JAMES G. BRIDGEMAN: There is a trend developing of individuals trying to obtain more control over many aspects of their lives, including the development of more healthy lifestyles as well as the planning of their own financial futures. The personnel directors of certain large corporations are beginning to help their employees in this endeavor. As insurers, in conjunction with our group insurance and group pension business, should we be working with these personnel directors?

MR. GIVENS: In the areas where we do have some expertise, a qualified and partial yes. Cafeteria compensation is an example where the carrier has a smaller area of ignorance than the client and can probably be of help. I am not sure, however, that we are particularly knowledgeable about how to make people healthier. Also, I would worry some about the issue of conflict of interest. Trying to make people healthier may help our health insurance business, but not our pension business. I am, also, fearful that we may lose our credibility by trying to advise in areas where we are not really experts.

MR. DYMOWSKI: I would agree that this is a very desirable approach. Corporate financers are very much concerned with the cost of benefit programs. As a result, in our discussions with some of our clients we make suggestions about risk avoidance and preventive maintenance programs. A group has to recognize that there is going to be some long-term gain, because initially there is a very definite loss.

MR. BRIDGEMAN: As a profession, it is possible to demonstrate the long-term advantage of this type of consulting. Have you seen any statistics that could be used to demonstrate any advantage?

MR. GIVENS: No, I certainly have not, with the exception of nonsmoker policies. It will take a lot of time to collect data and analyze it.