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NONPARTICIPATING LIFE PRODUCTS WITH NONGUARANTEED PREMIUMS

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Panelists: RICHARD A. SWIFT, MICHAEL P. TINE, WILLIAM T. TOZER

1. What are the basic concepts and purposes of the product:

    a. With respect to permanent insurance?
    b. With respect to term insurance?

2. What is the market potential?

3. What considerations (including state requirements) are involved in setting the premium rates?

    a. At issue - maximum and illustrated premiums
    b. Premium change mechanism

        (1) Retrospective "Experience" or "Future Expectations"
        (2) "Discretion of Management"
        (3) Considerations of Equity
        (4) Policy Form Wording

4. What other problems must be addressed?

    a. Reserves--basic and deficiency
    b. Nonforfeiture values; work of ACLI Task Force
    c. Approval as nonparticipating insurance
    d. Other state requirements

5. What are the tax considerations?

6. What are the reinsurance implications?

MR. DANIEL F. CASE: This session has to do with nonparticipating polices under which the company has the right to change the premium rate from time to time during the premium-paying period, subject to maximum premium rates specified in the policy. Because of the recent origin of this type of product, we are going to depart somewhat from Society tradition. We are going to give you not only facts, but also some appearances, and maybe even some impressions.

MR. RICHARD A. SWIFT: What is the future of nonparticipating permanent life insurance? Recent articles and reports indicate that this line of insurance is not selling well in comparison with participating insurance and nonpar term insurance. I expect that you have all seen many indications of this problem such as the following:

- "In today's inflationary economy, the outlook for nonparticipating permanent life insurance is not too promising." (David C. Silleto at Society of Actuaries meeting - April, 1979)

- "During recent decades, participating policies have generally been better buys." (Consumer Reports - February, 1980)

- "Buy term and invest the difference."

Recent developments that have contributed to the problems faced by nonpar permanent insurance include:

- Uncertain and unstable economic conditions. Conservative pricing assumptions that are required for traditional nonparticipating plans cannot hold up in this environment.

- Competition for consumers' disposable income has intensified.

- Consumerism is a contributing factor. More consumers are comparing costs. The insurance industry has also been the object of much attention in newspapers and magazines.

Fortunately, a number of life insurance companies are making changes in their products to meet the challenges posed by these developments. The most popular method currently being used by stock companies is the "non-guaranteed premium" concept.

The major reason for this trend to non-guaranteed premium products is that they appear to be the easiest solution to the dilemma being faced by most stock life insurance companies. The product is not as complicated as starting a participating insurance line, and is certainly easier and less costly than developing Universal Life or Adjustable Life products.

In viewing old Transactions, it appears that the concept was first used by Occidental in the early 1960's. A non-guaranteed premium policy was also introduced in 1972 by Crown Life. However, this type of policy did not receive a great deal of attention until 1979, when Aetna Life introduced their Aeconomaster policy. Because of an extensive filing effort, Aetna was successful in obtaining approval in almost every state for this policy form. Within the past year, a large number of stock life insurance companies have developed similar products.

The products introduced by Crown and Aetna were whole life plans. More recently, companies have been utilizing the concept for all forms of nonpar insurance, both permanent and term. New ratebooks have been developed with all or most of the products being non-guaranteed premium plans.

Concept

The non-guaranteed premium concept is not complicated. Non-guaranteed premium life insurance products are very similar to traditional nonparticipating plans. The major difference involves the ability of a life insurance company to change premium rates in the future. Comparing the premium concept to health insurance policies, a non-guaranteed premium life policy is quite similar to a guaranteed renewable health insurance policy, with regard to premium guarantees. The premium rates that the company charges are based on the actuary's best estimate of future mortality, interest and other actuarial assumptions at the time the rates are calculated. Any revisions in premiums are intended to reflect changes that are anticipated with regard to specified future actuarial assumptions. Thus, premium computations for this product are done on a prospective basis. This is a major difference between non-guaranteed premium products and participating insurance. Premium revisions are made uniformly for all policies of a given class - i.e. same issue age, sex, duration and rating class. Normally, the company's current premium rates are guaranteed for an initial period of 1, 2 or 3 years. After this initial period, the company can adjust the premiums to reflect current assumptions, but the premium can never exceed the maximum premium guaranteed in the policy form. These adjustments could be made on any policy anniversary after the initial guarantee period.

Purposes Served

This type of policy meets the policyholders' needs in an inflationary economy, such as we are currently experiencing. Changes in those assumptions which affect the premiums can be reflected in the policyholders' cost each year. This type of product should be more equitable to the policyholder than a traditional nonparticipating policy.

In an inflationary period traditional nonpar life insurance premiums are not competitive with par policies since premiums cannot be adjusted to reflect changes in the actuarial factors used to develop the premium rates. Thus, sales of traditional nonpar permanent policies have decreased in comparison with term and participating permanent life insurance plans.

Deficiency reserves are not required after the initial guarantee period if the maximum premium is equal to or greater than the valuation net premium. This is particularly important for plans with nonsmoker or preferred risk discounts. Extremely large deficiency reserves would be required on these plans due to the low premiums that can be charged to this select class of insureds.

Replacement of older policies by new ones is a problem currently being experienced by many life companies. This replacement problem should be minimized by this concept in the future since the policyholders' premiums can be adjusted as future conditions change.

Premium Considerations

The non-guaranteed premium concept can be utilized for all forms of nonparticipating insurance, including both term and permanent policies. In setting insurance premiums, the actuary can use pricing assumptions that are as realistic as possible. The actuary is not locked into "50 years" of insufficient premiums if his or her estimates of future assumptions prove to be too optimistic.

Mortality differences between smokers and nonsmokers can be reflected in the premium rates using the recent study published in the Transactions, even though the experience is based only on one company's statistics. If future mortality trends deviate from the anticipated mortality, adjustments in premiums can be made. The following illustrates possible mortality rates that could be utilized in arriving at premiums for this product. Of course variations would be necessary depending on the company's underwriting standards and markets.

Standard - 85% of the 1965-70 Select and Ultimate Mortality Table.

Nonsmoker - 70% of the 1965-70 Select and Ultimate Mortality Table.

Smoker - 110% of the 1965-70 Select and Ultimate Mortality Table.

The standard risk classification presumes no discounts for nonsmokers and no preferred risk classes.

More importantly for permanent plans, the actuary can utilize a realistic interest rate for future years. How many actuaries would feel comfortable assuming a 9% interest rate over the next 20 years, if the premium rates were guaranteed? However, in many companies, this interest assumption may be quite reasonable for a product where premiums are not guaranteed. Typically, a much lower interest rate is utilized for traditional nonpar products. For example, an actuary may currently use 8% for 5 years, grading to 6% at the end of 20 years. The premium rates developed using a 9% interest rate are going to be considerably lower for all permanent plans of insurance.

A number of companies selling non-guaranteed premium plans reserve the right to adjust premiums only for changes in mortality and interest in future years. Other companies reserve this right for changes in other actuarial pricing factors, such as persistency and expenses. As will be discussed later, some states require that the company state in the policy form what pricing assumptions will effect changes in premium rates. Companies licensed in those states will need to decide what these factors are before the policy forms are filed.

Maximum premiums normally are greater than premiums for a similar traditional nonpar policy. These maximum premiums are set high enough to avoid deficiency reserves, and provide a level of comfort to the company should interest rates decrease significantly in the future.

Reinsurance

I have recently reviewed a number of reinsurance proposals on non-guaranteed premium products. Basically, these proposals are the same as for traditional policies which are normally reinsured on either a YRT or coinsurance basis.

In some instances, a coinsurance proposal may be more liberal than with traditional policies, since the reinsurer would not have any deficiency reserves to set up. With coinsurance, the insurer would need to inform the reinsurer prior to making any premium rate changes. I anticipate that the reinsurer may reserve the right to make changes in their allowances when premium rates are changed.

Observations

Interest rate increases and mortality improvements in recent years have not benefited policyholders who purchased nonparticipating policies in the past. This is particularly true for permanent life insurance plans.

How much is the consumer going to benefit from non-guaranteed premium policies? Only future economic conditions can provide the answer to that question. However, if high interest rates continue, and mortality shows more improvements, there is no doubt that premiums will be considerably lower for non-guaranteed premium policies.

Since non-guaranteed premium policies provide insurance at a reasonable cost to the consumer in today's economic chaos, the product will play an important role in the life insurance industry during the 1980's.

MR. MICHAEL P. TINE: I will address the discussion topics of market potential, premium and tax considerations.

Market Potential

My comments, with regard to market potential, are directed primarily at permanent insurance.

I will start off by discussing current sales levels of several companies selling the non-guaranteed premium product. I informally surveyed five companies, including my own, that have been selling this product for at least six months and found that if you compare sales on such forms with sales on relatively comparable permanent forms with fixed premiums, the sales of the non-guaranteed premium product represent anywhere from 30% to 80% of the combined sales. The percentages vary widely according to how long the company has been selling the product, with the average percentage being over 50. Of total permanent sales, these forms represent 20% to 30% for most of the companies. One company, which has been selling this type of insurance for many years, reported that the non-guaranteed premium product represents well over half of their total sales.

The prediction of actuaries from all of these companies, including two other actuaries from companies which just recently entered the market, is that the sales potential of this type of insurance is enormous, and many feel it may easily displace most, if not all, traditional nonparticipating insurance in the years ahead.

My own feeling is that there will continue to be a sizable market in the foreseeable future for traditional fixed premium nonparticipating insurance among those agents and consumers who want the protection of total guarantees and/or are simply comfortable with traditional nonpar insurance. However, I do agree that if interest rates remain relatively high for the next five to ten years, the presssures on traditional nonparticipating insurance will be so great that these new forms will displace the majority of traditional sales.

However, notice that I am speaking more of displacement rather than additional sales. The advent of this product will not cause total industry life insurance sales to increase substantially, but rather will result in a redistribution of sales. While this product will have some appeal among customers and agents of participating insurance, it will have the greatest appeal among those looking for the lowest possible premium for permanent insurance right now. The more competitive participating policies will continue to show a better net cost than these new nonparticipating forms unless high interest rates are used to make the net cost comparison. Therefore, most of the sales will come from traditional fixed premium nonparticipating forms while there will be some displacement of participating insurance as well.

My prediction is based on a continuation of relatively high interest rates for the next five to ten years. Although most companies will reflect changes in both mortality and expenses in their premiums, clearly the interest rate will play the biggest role in both the initial premium level and any future adjustments. The concept will be attractive only if people are convinced of a long term continuation of high interest rates (possibly improved mortality experience), and so long as companies can either reduce premiums or at least not increase them. If interest rates fall and premiums must be increased, it will hurt the marketability of this form substantially, even more so than a decrease in dividend scales for participating insurance since a premium increase will be much more visible to both the agent and the consumer than a change in the dividend flow.

While current high interest rates have made this type of insurance attractive in the marketplace, in a sense this is probably the worst time to introduce such a product since the probability of interest rates falling in the future is certainly a possibility. But as in the stock market, where there seems to be the greatest enthusiasm to buy when prices are very high, these current high interest rates certainly result in a fertile marketplace for nonparticipating products with premiums that can change. I simply hope, as an Actuary of a company with such a product, that I am not faced with having to raise premiums three, five or ten years from now. If that were to happen, traditional fixed premium nonparticipating insurance would become a more viable product in the marketplace again.

Premium Considerations

Mr. Swift mentioned the assumptions that must be set in pricing these new forms.

Unlike traditional nonparticipating insurance, the setting of assumptions is necessary not only for establishing the initial premium rates, but perhaps even more importantly as the basis for making future changes in the premiums.

But as with any other product, there are many practical considerations in setting the premium rates. The most obvious is that the rates must bear some reasonable relationship to your own traditional fixed premium nonparticipating forms. The initial rates must be lower than your traditional forms to attract a buyer, and the maximum rate cannot be too high in relation to either the initial premium or other traditional forms.

An equally important consideration is competition. Not only must the initial rates be somewhat lower than most traditional nonpar rates, but also competition from participating contracts must be considered. Competition from aggressive participating insurance has been a prime motivator for companies introducing these new nonparticipating forms, and therefore the rates must be set with that competition in mind. The actuary must consider the illustrated net cost of participating policies in pricing the initial premiums, and must consider the gross premiums charged for participating insurance in setting the maximum premium for this form.

I will now address the question of equity. This is a question that company actuaries must be concerned with, and indeed is also a question that actuaries from several state insurance departments have expressed concern over. There are at least six states which have adopted some form of regulation or guidelines for this insurance, and two or three more states are considering regulations. While the primary purpose of these regulations is to assure proper disclosure of premium rates and their nonguaranteed nature, they are also directed at ensuring equitable treatment for policyholders.

At original issue, the question of equity is one of equitable treatment as compared to traditional fixed premium nonparticipating insurance. Certainly the forces of the marketplace play a role here in that if the initial premium is too high in comparison to traditional forms, one would sell very little of this insurance. Indeed, two states actually require that the premiums be lower than premiums which the insurer would be willing to guarantee in a fixed premium policy. Some other states require the filing of premium rates or assumptions.

The more difficult question is how to maintain equity after the point of sale, when premium changes are, or should be, made. Certainly the marketplace will help assure equity, but clearly not to as great a degree as at original issue. While the maintenance of equity is the actuary's unique responsibility, there are several states requiring some kind of evidence that equity is being maintained. Four states want the premium rates filed 60 days prior to a change so they can review them, even though they do not have rate control over life insurance. Two of these states have asked companies to give them the right to disapprove the change. Three states require the filing of assumptions with a justification of any changes. Other states have considered requiring a certification that the assumptions used to adjust the premiums on i force policies are consistent with those being used in setting premiums for new policies.

While New York State has not yet approved these new nonparticipating forms, their concern about equity has caused them to consider imposing guidelines similar to those specified under Section 216 for participating insurance. That section has reporting guidelines, and perhaps more importantly, profit limitation guidelines for stock companies selling participating insurance. Since one of the profit limitations in Section 216 is $.50 per thousand of insurance, and since Section 216 is extraterritorial, the direct application of Section 216 to these forms would certainly be vigorously fought by companies licensed in New York State.

Although I do not support limiting the profitability of this type of nonpar insurance, a good principle to follow to assure the equitable treatment of existing policyholders is to view this product as a fixed profit nonparticipating form. Essentially when the pricing assumptions are set at original issue, those assumptions define a certain anticipated profit margin from this business. As the actuary modifies his or her outlook as to future expected interest, mortality, etc., the premiums are changed such that the profit margin under the new expectations is the same as was anticipated under the original assumptions. I should mention that when changing the premiums on forms which guarantee one or more pricing factors, only the change in future profits from the non-guaranteed factors are considered in calculating the new premium.

The concern of some states, although not stated specifically in these words, is essentially that the profit margin originally set will be modified in the future, thus not providing the policyholder the full benefit of future experience. The concern is that once we get the policyholders on the books, we will either raise premiums or not lower premiums enough, thereby increasing the profit margin over that originally anticipated. These states feel, and I agree, that this results in unfair and inequitable treatment of inforce policyholders. However, if the profit margin from the non-guaranteed pricing factors is kept constant as assumptions are updated, policyholders will automatically receive equitable treatment.

That leads me to the next subject of methodology to be used in changing premiums. I advocate a methodology which involves equating expected future profits after the change in assumptions and premiums with those expected before the change. Obviously, profits can be expressed in a variety of ways (i.e. percent of premium, amount per thousand, return on investment, etc.). Whatever the measure used, this methodology requires maintaining records of assumptions and anticipated profits. Then, when assumptions are changed, a premium is calculated such that the anticipated profits under the new assumptions are equal to the originally anticipated profits, remembering that any assumptions which are guaranteed are left unchanged from those originally anticipated in this calculation.

The state regulators will be watching us. Our actions will speak much louder than our words, and if we develop a record of equity, there will be much less future regulation than otherwise.

Tax Considerations

The major tax issue with these forms of insurance is whether the difference between the actually charged premium and the maximum premium is a dividend for the company's federal income tax. I know of at least two companies who have asked for a private letter ruling from the IRS on this issue. While no final decision has been rendered, the IRS's current position is that it is a dividend. I understand that the basis for their position is the fact that the premiums actually charged are at the discretion of management and are a result of company experience. Regulation 1.811-2 is cited, which states that, "the term (dividend) includes amounts returned to policyholders where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management"; the regulation further states, "similarly, any amount refunded or allowed as a rate credit with respect to either a participating or a nonparticipating contract shall be treated as a dividend to policyholders if such amount depends on the experience of the company".

The significance of considering that the difference in premiums is a dividend varies depending on a company's tax phase. I will briefly comment on the tax effects on companies in the four basic tax situations described in John Fraser's paper, but I will not include the complication of a company which changes from one tax phase to another.

This issue has the greatest significance to companies whose tax position is situation A. That is, companies whose gain from operations before deductions is less than taxable investment income. This is also called "Phase II negative". Because deductions for dividends to policyholders are limited to $250,000 for companies in that tax situation, most if not all of the difference between the actual premium charged and the maximum premium would result in an increase to the gain from operations without a corresponding increase in allowable deductions for dividends to policyholders. This would make the economics of this product for such companies totally unacceptable.

Companies in tax situations C or D, often called "Phase II positive", would also be hurt by such an IRS ruling, but not as severely. While the difference in the premiums would increase the gain from operations before deductions it would be offset by an increase in the deduction for dividends to policyholders. Where the company would be hurt is in the loss of the 3% special credit for nonpar premiums.

Companies in situation B, "Phase I", would not be affected.

Because this issue has such a sizable economic impact on companies in situation A, there is no question that a ruling to call the difference in the premiums a dividend will be fought vigorously.

There are no peculiar or special premium tax, personal tax, or other company federal income tax considerations that I am aware of for this product.

MR. WILLIAM T. TOZER: The insurance market is currently in a very changing but interesting and exciting period. There are large sections of the market that are very interested in permanent death benefits. In addition, there are those that are interested in a premium that is essentially level during their lifetime compared to the steeply increasing costs mandated by renewable term insurance. Nevertheless, these people have come to the conclusion that very little will be sold in the future with long term guaranteed fixed premiums. The public reached this conclusion when mortgage lenders stopped providing mortgages with fixed long term interest rates. Moreover, there is a section of the marketplace that would prefer a product other than participating life insurance. The non-guaranteed premium permanent life insurance product is a possible answer.

Policy Form Wording

The premium for this product may be stated in the policy in several ways. I will describe the three most common approaches.

The first approach has the premium as a stated amount for a guaranteed period of time, such as two or three years. The policy then states a higher premium after the guarantee period. This higher premium is the maximum premium that can be charged for the policy. The policy further states that the company reserves the right to reduce this higher premium for any year after the guarantee period. This clause never addresses rate increases, only rate reductions. This approach is in a strong position to meet the requirements of the reserve and nonforfeiture laws.

The second approach has the premium as a stated amount and this amount is guaranteed for a period of time, such as two or three years. The policy then states that after the guarantee period, the company can adjust the premium up or down, but not above a maximum stated premium. This approach more strongly emphasizes that the premium may either increase or decrease. As I will discuss later, this approach can create nonforfeiture and reserve problems.

The third approach states two sets of premiums in the policy. The first set consists of premiums the company anticipates charging in the future. The second set consists of maximum premiums the company can charge. Although both sets of premiums need to be presented to the policyholder, the policy form is the wrong place. Including both sets of premiums in the policy creates greater complications with nonforfeiture and reserve requirements.

Reserves

The Commissioners Reserve Valuation Method requires the modified net premiums to be a uniform percentage of the premiums specified in the policy. A policy form that includes only the maximum premiums and permits the company to charge a reduced premium does not require special handling under the valuation law. Since the only premiums stated or implied in the policy form are the maximum premiums, the modified net premiums must be a uniform percentage of the maximum premiums. Likewise, when the company charges a reduced premium, the reserves are not changed since the charged premium does not affect the modified net premium in this situation.

A policy form that states a non-guaranteed current premium that can be raised to a maximum level may have two premium schedules - a stated maximum schedule and an implied current schedule. As a result, should reserves be based on modified net premiums that are a uniform percentage of the maximum premium schedule or the current premium schedule? Another approach would require the reserve for each duration to be the greater of the reserve based on the maximum premium or the current premium schedule. If reserves are based on modified net premiums that are a uniform percentage of the current premium schedule, a redetermination of reserves could be required when the current premium scale is changed. This would not only be expensive administratively, but the method could be complicated and subject to disagreement.

A policy form that shows both the maximum premiums and the current premiums has definitely two specified sets of premiums. Consequently, the valuation law may require the reserves for each duration to be determined on both the maximum premium basis and the current premium basis with the greater of the two reserves to be used as the required reserve for that duration. In addition, a change in the current premium scale could not only require a change in the reserves, but may also require policy endorsement.

The insurance departments are taking a practical approach. For example, the Arkansas Insurance Department states in Bulletin 5-79 that all reserves shall be based upon the maximum premium rates and shall be independent of the premium rates in effect. The state of Oregon states that all reserves shall be based upon the expected premium rates initially filed and shall be independent of the premium rates actually charged. The state of South Carolina states that reserves shall be based on the maximum premium rates.

The Standard Valuation Law states that deficiency reserves shall be based on the actual gross premium. Again, are the actual gross premiums the current premiums or the maximum premiums? The basic reserve is concerned with the changes and slope, not the actual level, of the gross premiums. Consequently, a policy could have the same basic reserves based on either the current premium or the maximum premium scale if the current premiums were always a uniform percentage of the maximum premiums. Deficiency reserves are based on the level of the premiums. Consequently, a policy that includes both of the premium scales might not be deficient based on the maximum premium schedule, but could be deficient based on the current premium schedule. In addition, when the current premium scale is used in determining deficiency reserves, a redetermination must be made when the premium scale is changed. Philosophically, if not legally, deficiency reserves should be based upon the maximum premium scale. Deficiency reserves are established to ensure that there is sufficient future premium income to meet future benefits. Since a company has the right to raise its rates to the maximum level, it is unnecessary to establish deficiency reserves on a more conservative basis. Many insurance departments seem to agree.

Since Arkansas states that all reserve functions shall be based upon the maximum premium rates and shall be independent of the premium rates in effect, deficiency reserves should be based upon the maximum premium rates. Again, South Carolina states that reserve functions shall be based upon the maximum premium rates. The state of Texas clearly states that deficiency reserves are required to be calculated using the maximum guaranteed premiums. Since Oregon states that all reserve functions shall be based upon the expected premium rates initially filed and shall be independent of the premium rates actually charged, deficiency reserves might be based upon the non-guaranteed premiums at time of filing.

Nonforfeiture Values

The Standard Nonforfeiture Law states that the adjusted premiums for any policy shall be a uniform percentage of the respective premiums specified in the policy. As a result, policy forms that use the first approach would have adjusted premiums that are a uniform percentage of the maximum premiums. Under the second approach, adjusted premiums would be based on the maximum premiums or possibly the implied current premium scale. Consequently, the second approach has the possibility of two interpretations. The third approach is confusing with the two premium scales specified in the policy. As a result, the company would probably be required to develop a set of cash values that contains the greater of the cash values developed using the maximum and current premium scale.

Whenever a policy form contains wording that requires cash values to be based upon the current premium scale, complications may occur when the premium scale changes. For example, are cash values based on the premium scale from the date of issue or from the date of the latest change? If cash values are determined from the date of change and the slope of the future premium scale is unchanged, there is little or no change in the current and future cash values. However, if the cash values are based upon the premiums from the date of issue, in all probability, cash values will change. Any reduction in cash values will create confusion in the minds of the policyholders, if not actually create legal problems. Beginning with the current cash value may require a different set of cash values for each issue age and issue year. This obviously increases the complexity of administration. If cash values are based on the current premium scale, premium scale changes may cause misunderstandings. For example, cash values would be reduced when the premium scale is increased and cash values would be increased when the premium scale is decreased. The policyholder is going to be displeased when a premium rate is increased while also reducing cash values. The company would prefer to raise rates an additional amount and not reduce the cash values. As a result, this approach would tend to cause larger premium increases. Likewise, since a reduction in premiums would require increased cash values, premium reductions will be smaller. For these reasons, it is important that companies avoid basing their cash values on current premium scales. Many insurance departments seem to share this concern. The states of Arkansas, South Carolina and Texas state that all nonforfeiture functions shall be based upon the maximum premium rates and shall be independent of the premium rates in effect. The state of Oregon states that all nonforfeiture functions shall be based upon the expected premium rates initially filed and shall be independent of the premium rates actually charged.

Since cash values are based upon the slope and not the level of the premium scale, a policy would have the same set of cash values based on either the maximum premium scale or the current premium scale provided both scales are level. Likewise, the same cash value schedule occurs when the maximum and the current premium scale both have the same slope. There is concern, however about the following possible situation. A company develops a policy with an increasing guaranteed premium scale and includes in that policy the minimum cash values permitted by law based on this increasing maximum premium schedule. This policy would have cash values substantially below the minimum cash values for a level premium contract. However, the company establishes the current premium on the assumption that it will remain level. The company states verbally and in its sales material that it plans to continue the current premium if current conditions remain unchanged. Under these circumstances, this company is offering a non-guaranteed level premium contract with cash values substantially below those required for a guaranteed level premium contract. In the extreme, a company could develop a set of guaranteed premiums that would develop no cash values. As a result, a company could be selling a non-guaranteed level premium policy with no cash values.

The American Council of Life Insurance formed a Task Force to study the nonforfeiture values and reserves for this product. This Task Force recommended that a company be prohibited from illustrating any set of nonguaranteed premiums which would produce nonforfeiture benefits greater than the nonforfeiture benefits specified in the policy. The decision of this Task Force was not unanimous. This recommendation was presented to the Actuarial Committee of the ACLI. The Actuarial Committee approved the recommendation and forwarded the recommendation to the Legislative Committee. The Legislative Committee returned the recommendation to the Task Force for reconsideration. Both the Task Force and the Actuarial Committee again approved the recommendation and the recommendation was then approved by the Legislative Committee and sent to the Board of Directors. The vote of the Legislative Committee was not unanimous and there is a section of the industry that does not agree with this approach.

The NAIC Life and Accident & Health Technical Subcommittee plans to propose several amendments to the Standard Valuation and Nonforfeiture Laws at the June, 1980 meeting of the NAIC. One of the amendments states that policies which provide for future premium changes by the insurer shall have adjusted premiums calculated on the basis of level premiums. However, if the policy contains two premium scales, two sets of adjusted premiums shall be calculated and the cash surrender value for each year will be the greater of the two cash values produced. In either case, no future changes in adjusted premiums and present values are required. I would anticipate that there will be some changes in this proposal before it is finally adopted. However, this proposal does emphasize the concern the insurance departments have about this product.

Other State Requirements

Various insurance departments are establishing procedures for this product. In some states such as Texas, they are in the form of regulations. In other states such as Arkansas, Oregon, and South Carolina, it is department guidelines, One of the items that is being required by some states is an actuarial certification. For example, the regulation adopted in the state of Texas requires, for policy form approval, a certification by a qualified actuary that the maximum premiums specified in the policy do not incorporate an increment in the maximum premium to increase the reduction in later policy years or to reduce cash values. The state of Oregon requires an actuarial certification when a premium is redetermined which states, (a) the premium scale is based on future expectations of interest, expense and mortality; (b) insureds have not been reassigned to new risk classes; (c) the relationship between old and new issues is reasonable and equitable.

Some states have established a set of guidelines for policy approval. Other states have established a series of guidelines for advertising, solicitation materials, and disclosure at the time of sale. The states of Arkansas, Oregon, South Carolina, and Texas are fair representatives of the type of procedures that are being developed.

The state of Arkansas has promulgated six guidelines under Bulletin 5-79. The first guideline basically requires the submission of advertising and solicitation material for approval. The second guideline states that all advertising and solicitation material shall give equal prominence to the maximum premium rates. The third guideline states that any use of the projected premium rates state clearly that the rates are not guaranteed and any comparisons with projected rates require the same comparisons with the guaranteed rates. The fourth guideline requires that the company consent to submit its rates for approval at least sixty days before they are used. The fifth guideline states that reserve and nonforfeiture values shall be based upon the maximum premium rates. The sixth guideline requires the company to certify they will comply with Bulletin 5-79.

The state of Oregon has developed nine guidelines to be followed for policy approval. The first guideline requires the company to submit its expected future premiums with the policy form at the time of filing. The second guideline states that any redetermined premiums shall be submitted to the department sixty days before they are used. In addition, it states that the redetermined premiums shall have the same slope as the originally expected premiums. The third guideline states that the company shall submit a short narration explaining the risk factors of interest, expense and mortality used in determining the premiums. The fourth guideline states that on redetermination of premiums, an actuarial certification must be submitted. The fifth guideline states that all advertising and solicitation material must be filed with the department. The sixth guideline states that all advertising and solicitation material shall give equal prominence to the maximum premium rates. The seventh guideline states that any comparisons made to the nonguaranteed premiums must also be made against the guaranteed premiums. The eighth guideline states that reserves and nonforfeiture values shall be based upon the expected premium rates filed initially. The ninth guideline states the company must agree with these guidelines.

The state of South Carolina has established the following set of guidelines. A senior officer of the company must certify that the policy is in compliance with the guidelines, that the policy will be merchandised in accordance with the guidelines, and that the non-guaranteed premium rates used to market the policy are lower than rates which the insurer could guarantee under identical conditions. A statement of the gross premium assumptions must also be submitted. The guidelines also state that the company will submit all rates for approval at least sixty days before they are used. Further, the maximum premium must be clearly stated in the policy and any advertising and solicitation material. The maximum premiums shall be given equal prominence. The frequency of possible changes in the premium must be stated in the policy. Any comparison to the non-guaranteed premiums must also be made to the guaranteed premiums. Reserves and nonforfeiture values are based upon guaranteed premiums.

The Texas regulations became effective May 8, 1980. The company must certify that the policy form and the advertising and solicitation material are in compliance with the regulations. The company must further certify that any premium redetermination will neither reflect a distribution of company surplus nor a return of previously collected premiums. Also, any non-guaranteed premium rates used to market the policy must be certified as lower than the rates which the insurer is willing to guarantee in an identical policy. All sales material must include a statement that the company reserves the right to charge the maximum premium beginning with any premium redetermination date, that the premium is not guaranteed beyond the current redetermination period, and that the premium at redetermination date is based on the company's expectation for one or more future cost factors including persistency, expenses, mortality and interest. The sales material and advertising must state the initial premium charge and the period of its guarantee, the maximum premium charge, and the frequency of premium redetermination dates. The insurer and agent can only refer in a sales presentation to the actual relevant previous or current charges for the plan, the initial charge and its period of guarantee, the maximum guarantee charge, the fact that future charges may be less than maximum, and relevant projected illustrations. These projected illustrations may be based on either actual previous or actual current charges, or both, provided that it is disclosed that such illustrations are based upon current projections of such items as persistency, interest, mortality or expense. If non-guaranteed premium rates are displayed in advertising and disclosure material, the maximum premium rates must be displayed with equal prominence. No policy may provide for premium changes more often than once per policy year. In addition, no insurer may, for premium redetermination purposes, reclassify into subclasses or new classes, the original classes established for a policy at its date of issue. The ruling further states that minimum nonforfeiture values and reserves are based upon the maximum premiums specified in the policy. It further states that reserves must never be less than the cash values.

GAAP

Actuarial GAAP assumptions are based on realistic assumptions plus an allowance for adverse deviations. The actuarial assumptions used in determining the current premium used by a company would be based upon fairly realistic assumptions. Normally, under GAAP accounting, these realistic assumptions should be loaded for adverse deviations. However, a company could include little or no allowance for adverse deviations in its GAAP assumptions provided that there is an adequate margin in the maximum premium rates to cover adverse deviations, and that the company anticipates that it will charge a higher premium if adverse deviations require. Likewise, a company should test its current premium scale for a possible loss recognition situation. If a possible loss recognition situation exists, the company should further test its maximum premium scale. If no loss recognition occurs under the maximum premium scale, the company may not need to recognize a loss. Since GAAP earnings should be a level percentage of expected future premium income, GAAP reserves should be based on the slope of the current premium scale, not the maximum scale. At the time the company changes its premium scale, the GAAP reserves generally should not require revision if the slope of the premium scale was unchanged. If the slope is changed, the statements I have made about statutory reserves based on the current premium scale must be considered.

MR. BRADFORD S. GILE: Although I am employed by Wisconsin's Commissioner of Insurance and represent Wisconsin on the NAIC C-4 Technical Subcommittee, I wish to emphasize that my remarks are solely my own opinion and may not necessarily be in agreement with opinions of my commissioner or of the subcommittee.

When I was first exposed to this type of product in 1974 or 1975, I was greatly impressed with it and I still am. To my mind, implementation of the concept that contractual benefits or premiums should be capable of being liberalized in favor of the policyholder when conditions clearly warrant was a revolutionary breakthrough and a giant step forward.

Because the product has such potential for greatness, we must at the outset guard against the very real potential for abuse. It has been pointed out here that several states have adopted guidelines or regulations for the approval of these forms. I note, from the brief descriptions given, that the various sets of guidelines contain some common features, but are certainly not uniform. Secondly, and perhaps more importantly, the enforceability of guidelines or regulations in this area may be very difficult. Rightly or wrongly, guidelines and regulations in other areas are being litigated by one or more companies who are affected by them, sometimes successfully.

In order to maximize effectiveness of regulations, serious problems should be handled by legislation, especially when abuses arise from a flaw in a statute. In this case, the primary problem seems to be the uniform percentage of gross premiums rule in the Standard Nonforfeiture Law for Life Insurance which, if left unmodified, would allow companies to defer cash values for as long as desired by devising "premiums specified in the contract" which have the right slope by duration. Such specified premiums could well bear no relation to those which the company actually expected to charge.

This is not a theoretical problem. It is very real, and currently exists with some fixed products having premiums which are nonlevel. With the additional feature of non-guaranteed premiums, the frequency and seriousness of such abuses may well be expected to rise dramatically. If effective permanent regulation is not done to prevent such abuses, the product's potential for greatness will be badly smeared, if not doomed altogether. Therefore, the first line of defense against both existing and future abuse should be statutory, preferably by amendment to the Standard Nonforfeiture Law for Life Insurance whose provisions, or lack thereof, seem to encourage such abuse. Guidelines and regulations should be used only as temporary measures until permanent statutory provisions can be enacted.

MR. CASE: I would like to make a comment based on my experience in working along with the ACLI Task Force that developed the recommendation that Mr. Tozer has described and in following the progress of that recommendation up through the committee structure in ACLI. We considered the possibility of seeking an amendment of the Standard Nonforfeiture Law, but we turned away from that approach for two reasons. First, it would take many years for enactments incorporating the model amendment to take effect in the various states. For example, the effective date contained in current draft proposed amendments of the model nonforfeiture law is January, 1989 for companies not electing an earlier effective date. The second reason is that the product is in its infancy, and we don't know what forms of it may appear on the market within the next several years. Although we feel confident that the proposed requirement is appropriate in today's climate, we would not want to freeze into law a requirement that might prove inappropriate a few years from now.

MR. GILE: I am also concerned that there is no statutory protection for consumers that a premium will actually be changed when it should be. I contrast that to participating insurance which has some degree of statutory protection in that surplus must be returned to policyholders in the form of dividends.

MR. TINE: Several companies have suggested that states should adopt a rule which would require that assumptions used to modify premiums on inforce policies be consistent with those used to price new policies. While this may not be a perfect solution to Mr. Gile's concern, it at least offers some degree of protection for the policyholders.

MR. RICHARD CHARLES MURPHY: It has been almost two years since our company started the development process for our varying premium nonparticipating product. Since that time, we have had the opportunity to direct significant resources into the investigation of some of the problems and opportunities raised with respect to these products. The following describes the advice I might give to a new company considering entering the market with a varying premium type product.

Background

First, there is some essential background reading. E. Paul Barnhart's paper on renewable health insurance discusses a number of the issues touched on by the panel today, including the question of participating vs. nonparticipating insurance. That paper also discussed various restrictions that might be placed on the company with respect to reclassification of risks after the initial issue process. Second, the paper by J. E. Matz and E. Paul Peters, which discusses the use of new money rates in participating dividend scales, would also provide appropriate background material. The point that they make with respect to the need to decrease dividends in a rising interest scenario at later durations and older issue ages should be considered carefully by a company examining this product.

Rerating Process

Before any decision is made to enter the market, the company should have a good idea of how it is going to rerate a product. What factors will it use in the rerating process? Will it use the asset share approach in the rerating process? Will it use a defined formula that will reflect the factors of interest, mortality and expense? Just how will the rerating be accomplished? There are many alternatives and many different methods that can be employed. Some of the methods will have peculiar effects. They might, for instance, defer profitability for a long period of time in a rising interest rate environment. Depending upon the formula, early withdrawals could create decreases in rates. Spend some time thinking about the problems that will be encountered in the rerating process. It may be found that the expense of rerating will militate for a different approach to the policy development process.

Management Discipline

I hope that in a few years the standards for the determination of dividends will be applied to varying premium type contracts. I also hope that we see the requirement that assumptions in the rerating process must be always at least as favorable as those used in the rating of new business. Management should understand that they are giving up windfall profits. No longer will a surge in interest rates lead to large unanticipated profits. Those profits will be given back to the policyholders. Management should understand that there is an implicit guarantee to the public that they will benefit from changing environmental circumstances and they should benefit at least to the same extent as new business.

Product Design

The IRS questions present very real issues. There are several approaches that can help to defer the problem with the IRS.

- Gradually increase the maximum premium rates at a rate of 2% a year. At least this will minimize the amount of income that the IRS has contended should be taken into the gain from operations.

- Guarantee the rates 2 years in advance. This might serve to lessen the IRS objections, although I would not hold out much hope for this approach.

- Adopt a company policy with respect to reissue of nonparticipating policies at lower rates on a periodic basis. Unfortunately this may lead to a very large deficiency reserve problem.

- Work with the NAIC Technical Subcommittee to encourage the adoption of the language that Ted Becker introduced at the Technical Subcommittee meeting in Tampa in April. If I understand that language correctly, it would not be necessary to include a maximum premium in the contract for this type of policy. If there was not a maximum premium included, then only the current premium could be brought into income. This would not eliminate all of the IRS arguments, but it certainly would eliminate their major contention that income is the maximum premium.