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RECORD

PREMIUMS AND DIVIDENDS—PARTICIPATING INSURANCE

Moderator: ***HAROLD G. INGRAHAM, JR.*** *Panelists:* ***RICHARD M. STENSON, WILLIAM M. SNELL, THOMAS C. SUTTON***

1. The relationship of surplus goals, dividends, and equity principles ...and the annual splitting of "earnings" into:

    a. Surplus contribution
    b. Dividends, and
    c. Growth (i.e., investment in new business)

2. Appropriate levels of surplus

3. The relationship of the assumptions to:

    a. Recent company experience,
    b. Future company plans, and
    c. The perceived economic and competitive environment

4. Critical issues

    a. Allocation of investment income between and within lines (consider IYM, policy loan recognition expenses, and federal income taxes)
    b. Preferred risk...the basic decision whether or not to do it...how it should be done ...the impact on other business, substandard, etc.
    c. Upgrading existing business...exchange offers
    d. Recognition of variations in assumptions by issue age, plan, and size
    e. Other unusual design and assumption decisions

5. Status of the Dividend Philosophy Report

Surplus

MR. HAROLD G. INGRAHAM, JR.: How do companies reconcile growth and surplus needs? What limits should be place on growth?

MR. WILLIAM M. SNELL: Being a Phase I Company we are very concerned about the amount of surplus we have. We do not want to accumulate too much surplus because of its implications in our Federal Income Taxes. Also, we must set up the mandatory security valuation reserve. We look at both -- what is our ratio of surplus to reserves and also our ratio of surplus plus MSVR to reserves. Traditionally we follow the 10% rule that New York State has of not having surplus in excess of 10%. We used to have about an 8% surplus ratio in the days before MSVR, but that also was to cover investment fluctuations. Now with MSVR we see less need to have surplus that high and we have generally tried to reduce the ratio to about a 6% level.

We also follow generally the New York limit of 15% growth in new sales under most situations. We realize there are abnormal conditions which result in increase in sales that are not due to company campaigns or will not cause expenses to go up that cannot be recouped. For example, a new policy series might be developed that will take off and your sales will increase quite drastically. Shortly after World War II sales of all companies were up, similarly after the Korean War. Things of this sort will cause sales to increase and you will not have the unusual expenses that you cannot really cover under a normal pricing mechanism. So we like to maintain a healthy growth in business based on the economy. Recently, with the lowering of premiums we find our sales have been going up faster, more like 25% a year than the 15% that we were used to in the past. I think a lot of this is due to good recruiting of agents, college agents who set their sights a little bit higher than maybe it was true in the past when agents tended to be coming to us from other professions.

MR. INGRAHAM: How do you define the "earnings" element invested in growth? Should it cover all new business, new business in excess of replacement levels, or new business in excess of that in the previous year? How should "fixed" or "overhead" expenses be handled? Is this a meaningful concept on a "going-concern" basis?

MR. RICHARD STENSON: This question sounds almost as though we are discussing a GAAP approach for mutuals; a new way of looking at the earnings of the company in terms of splitting out the requirements for new business before we look at the amounts available for dividends and for surplus.

We are all used to the phrase "Investment in New Business" or "New Business Strain" in the conventional asset share pricing sense. That is, the net excess, for each policy cell, of total acquisition and other expense, first year claims and reserves over premiums paid in the first year. If we think of it in the context of the company's total results for the year, dealing with the aggregate financial picture, some other possibilities suggest themselves. What do we mean by new business in this sense? Again, conventionally, it is all the policies issued in a year, and this is logical. But if we are concerned with financial planning and the use of resources, the conventional definition suggests that one of our options is to get out of the life insurance business. One alternative definition would be to consider investment in new business beyond a business as usual year, where a business as usual year might be one supported by net earnings on an ongoing basis. This could be determined as the amount of sales necessary to replace the policies terminated in a year, to keep the total book of business where it is. In an inflationary economy and expanding insurance market it probably should reflect some sort of underlying growth level. Any of these definitions, though, would be arbitrary in one sense or another. Since the point would be to determine the earnings element being used to support new business growth beyond "business as usual" levels, we could start the definition in the other direction. Try to isolate the cost of significant changes to marketing, sales or products intended to stimulate growth, and define these as the investment in new business. This is sort of a differential approach to defining new business, suggesting a differential treatment of expenses, that has been discussed at various meetings. It recognizes the existence of a body of fixed overhead expenses that may not change very much with volume. This can be a valuable tool in financial planning if rooted in reality, if it recognizes, better than traditional approaches, the true dynamics of the business. It is not going to be useful at all if it results in bodies of expense being pushed around to policy groups in an illogical or inequitable manner.

On the "going concern basis" one could argue that the definition of investment of business is not of any great significance. Total earnings after investment in new business, however that is defined, is, after all the only real source of dividends and surplus in a mutual company. Equity demands that the allocation of a total dividend among the participating policies reflect a rational and logical distribution of the total expense for the company.

MR. INGRAHAM: Before I go on, I would like to make one comment on the question of how fixed or overhead expenses should be handled. I think it is pretty self-evident that, as far as the allocation of overhead is concerned, the expenses can be arbitrarily allocated in any number of ways by the percentage of assets or relation of premium, total income, expenses, personnel or any other number of things, ways, or combinations. But the very nature of these amounts do not reflect expenses that can be easily allocated to reflect cost of services for a particular line of business or within the line for a particular product.

So you get plenty of leeway in any corporate overhead allocation procedure. It is important that whatever line of business gets allocated the overhead, in whatever proportion, you know that that line can really support the allocation and the pricing. Now some lines of products by their very nature are low margin operations and therefore are not in the position to support large amounts of corporate overhead for others. Each line of business should be analyzed, and no line or product should be allowed to continue if it does not contribute profit on that basis.

MR. INGRAHAM: Is it equitable and justifiable to have surplus targets that will vary by line of business and growth rates permitted to differ between lines?

MR. THOMAS C. SUTTON: One purpose of surplus is to provide a hedge against adverse financial results. From that perspective, surplus could be called an "adversity fluctuation fund." So, it follows that surplus targets should be related to the potential risks undertaken by the company. To the extent that those risks differ by line of business, corresponding differences in surplus targets by line of business are certainly justifiable, and are in fact necessary.

Assuming that the surplus targets are set, the more practical problem is the determination of the appropriate annual increments to surplus. At one extreme, a requirement that surplus targets be achieved each and every year might preclude any significant growth. Conversely, if no maximum rate of growth is imposed, there may be an increasing gap between the surplus targets and the actual surplus. Between these two extremes lies the abyss of management judgment. A balance is required between the cost of loss opportunity and the cost of financial adversity. I would favor giving more weight to the cost of financial adversity, since lost opportunity rarely causes insolvency.

On the question of equity among lines of business, I would respond assuming that the company has a "permanent contribution to surplus" philosophy. That is, the company expects and exacts charges for risk assumption which are not distributed to the blocks of business giving rise to those charges. Then that accumulated permanent surplus could appropriately be used to subsidize new lines of business or exceptional growth rates of existing lines of business. If that permanent surplus were to be exhausted, then further inroads of one line's surplus in favor of another would, to me, raise questions of equitable treatment.

Having said this, I still have a general discomfort with making statements about surplus. Trowbridge's paper provides a good consistent theory, but the implementation raises many unanswered questions. Our theories of surplus are not very well developed in terms of the risks and the amounts necessary to support those risks. A basis element underlying any surplus theory is the accounting system together with the methods of valuing assets and liabilities. Without a sound basis for those items, then the amount of surplus is not known, and answers to these other questions become moot.

MR. INGRAHAM: With respect to the company's general portfolio, how should common stock policy be related to surplus needs and desired growth rates? In fact, should commons be held at all?

MR. SUTTON: First of all, surplus capacity is called on to recognize the downslide potential in common stocks. To the extent that commons are a significant percentage of surplus, the capacity used becomes quite large.

The property/casualty companies, which traditionally have held a much higher percentage of surplus in commons, have suffered great losses of capacity on this score, and the corporate options of life insurance companies have also been affected. The holding of commons is based on the questionable belief that, in the long run, greater after-tax yields can be obtained than for fixed dollar securities. However, the surplus constraint makes dollar cost averaging in commons rather difficult. Life insurance company investment officers have had a spotty record in common stocks in recent years - probably because they seem to follow principles which are proper for unconstrained portfolios such as pension funds, where continued cash flow makes dollar cost averaging a lot more feasible. It seems to me that this leads to the following conslusions:

> Income, rather than total investment return, including unrealized capital gains and losses, should be a company's principal investment criterion. Given the competitive pressures on product pricing, and the failure of companies to build surplus through equity investments in recent years, there should be no material sacrifice in current income in order to achieve capital gains.
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> Fluctuations in the prices of commons, which are valued at market, can distort and frustrate the achievement of surplus goals. And, capital gains from commons have not been a source for building surplus for the past 15 years. So companies have been forced to build surplus by contributions from operating gains.
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> However, a case can be made that <u>some</u> minimum amount of commons should be held. If a company does not hold any capital gains - generating investments, then a portion of net income must be retained and not distributed to policyholders, in order to build a reserve for credit losses from fixed-income investments. Tax considerations make it much more desirable to offset these losses with capital gains rather than setting aside after-tax income.

MR. INGRAHAM: Will the relative need for surplus for the ordinary lines increase or decrease over the next few years? What forces are causing changes?

MR. SUTTON: Before I comment on that question, I would like to observe that common stocks do not appear to be useful in immunizing assets and liabilities. Clearly, that is true with respect to traditional products. There was a time when people believed that there would be a movement of common stock values that was relatable to inflation and that by having some portion of common stocks in the portfolio, one might at least immunize oneself against changes in liabilities associated with cost of living riders, but that idea has proven to be fallacious.

On surplus needs in the future, I think that the relative need is going to decline for the ordinary life line. In making this statement, I am speaking about the traditional ratio of statutory surplus to liabilities.

One reason for this decline is the larger proportion of investment in riskless policy loans. This is not necessarily a desired objective on the part of the companies, but it is happening automatically. With respect to the remaining assets, the last six months have demonstrated that it is almost impossible to hold amounts of surplus so large that they are going to cover any possible adverse situation. Companies, to the extent that they can, may tend to try to change the risk rather than increasing surplus. One way to change the risk is to shorten the length of maturities and I think that just about every company has consciously gone to shorter maturities in their investment policy. One of the traditional investments of course, is mortgage loans, and a bill is now in the Congress to make it permissible to have three to five year renegotiable mortgage rates. That, in effect, substantially shortens the term of a large block of our non-policy loan assets, and accordingly reduces the risk arising from interest rate fluctuations. I have not seen any signs of what is happening to bonds but it is conceivable that the actual instruments themselves will be changed to shorten the period, by having shorter call periods or some elements of renegotiation on a more frequent basis. So, for those reasons, the risk associated with rapid increases in interest rates may be more controllable. That is really the only viable option since the amount of surplus that would be necessary to cover a situation such as we have just had is not practical to hold.

Political pressure and social pressure have been brought to bear on life insurance companies by questioning the necessity and usefulness of surplus, and whether it is there for the benefit of the policyowners or for the benefit of company management. This pressure will influence companies to avoid levels of surplus which appear clearly redundant. Tax planning, mentioned earlier, is also a very powerful force, which for Phase I companies is going to prompt them to have as low a level of surplus as possible without reducing some of the abilities of company management to have flexibility required to enter into new activities. Not the least of pressures leading to lower surplus levels is the increasing competitive environment. So all in all I think that relative surplus levels will decline for the ordinary line over the next five to ten years.

MR. INGRAHAM: In the light of competitive and consumerist pressure (and, in New York, legal requirements), can companies reasonably expect to retain surplus much above a 5-10% of liabilities level? Doesn't this severely restrict the range of choices in this matter?

MR. WILLIAM SNELL: I doubt if surplus ever rides much above the current levels, as Tom Sutton suggested. Surplus cannot handle all of the contingencies that could come upon us. We have to be very careful of the double whammie that Harold talked about, both the policy loan problem and the pension disintermediation. The investment people have to definitely look at their cash flow situation. We really have to look at some of the other things we can do in order to not restrict choices. We do not want to restrict choices if at all possible to be competitive in this rapidly changing product mix.

For example, we want to be sure that we can do everything possible to have persistency as good as it possibly can be. We want to do everything possible to keep surrenders from increasing as rapidly as they have been this year. However, with inflation being a factor, there is a limit to how long we can amortize expenses even with good persistency, or we are really paying for expenses with cheaper dollars. We need to watch our unit expenses very carefully to be sure that the bottom line still looks good. At Northwestern we have a very sophisticated outgrowth of the LOMA unit cost study by product line, so we can tell the client what the cost is that does tie into the LOMA study. This helps us keep our cost down and provides us with the opportunity for more opportunities to make changes in the rapidly changing needs of the public.

MR. DONALD CODY: Consider the different risks on different kinds of contracts. By issuing a certain increase in the business on a particular line or a particular product in the year, you have indeed used up your capacity further, and it is very interesting to take a look at your bottom line after dividends and charge against it, the expense of which you have used the capacity that the company is issuing. This really measures the extent to which a line or product has indeed contributed to the surplus of the company. This of course involves having some kind of a surplus theory which you can arrive at by brute force. I would say this about the size of surplus that companies are going to have to hold, and that is if the recommendation is to valuation bases that are now currently being suggested, we damn well better have better surplus, because surplus obviously is dependent upon the extent of conservatism in your reserves. If you remove that conservatism you have got to put it into surplus.

MR. INGRAHAM: To sharpen that point, are you concerned about mixes of business having to do, for example, with group annuities and the way that assets and liabilities are invested short or long?

MR. CODY: Well, you probably need a surplus of 4 - 5% of liabilities to take care of defaults in a depression. Various lines have different interest change risk requirements. Today, the life insurance line is a line where the assets are shorter than liabilities, so that your risk is on the down side. What sort of a scenario should you take for down side risk? Should you consider that maybe in 30 years we might get down to 4% or 3.50% or 3%? I do not know. Actuaries have to ask that question, but no economist would be crazy enough to try to answer that question. On the other hand, your investment contracts have guaranteed values on a book basis. You cannot protect against this by the interest basis of your reserves; it has to be a percentage of the actual cash value. This percentage might be 1%. You might need a 5% risk with a 1% change. I do not know how much of that ought to go into reserves, but obviously the extent to which you put it into reserves, the less you need for surplus. I think the question you have to ask is whether or not a company without a high surplus can afford to issue this kind of contract. Some companies which are very healthy do not issue it.

MR. PHILLIP SHORR: From some of the comments I have heard, I see a very nasty paradox kind of looking at us here that I am not quite sure of the answer to, and I would be interested in the panelists' comments. Let us say we have two lines, Line A and Line B, and it turns out that Line A is a problem line and has recently experienced losses that compel the company to dip into Line B surplus to help cover those losses. In the future, it seems to me from an equity standpoint it is up to Line A pricing to be set to restore that surplus borrowed from Line B. At the same time, the market situation is such that you really cannot afford to price it at that higher level, for you will not sell any business. Where do we go? How do we resolve that question between equity and the pricing you have to use to sell any of your business.

MR. SUTTON: In a short term, or what is perceived to be a short term, difficult situation, surplus by line of business is undoubtedly maintained as an internal accounting item. In a company that has an investment year process for allocating interest, that surplus is going to affect the allocations of interest. As a result, interest allocated might be negative for one line and positive for another. As long as you do not reach the point where there are significant impacts to the overall company, the equity between lines is probably not going to be disturbed. But of course, surplus is there for the solvency of the entire company and you cannot let one line of business go insolvent at a time and then disgard it and let the others continue. So there is a point at which it is going to result in inequities if the company gets into continued long term and severe problems. But again on a short term basis, I do not think that there would necessarily be any inequity among lines of business. However, the outcome could depend on the allocations by lines, both for surplus and investment income.

MR. INGRAHAM: Just one little addendum to that, some product lines have high surplus needs but involve very low probability situations and they have low profit margins, and other lines have high profit margins, or they did in the past, anyway. In a sense they have contributed to the surplus needed to launch the high surplus and intensive products. Thus, as long as you can monitor the unfolding experience, you can temporarily tolerate a situation where surplus is to be borrowed by a line subject to a plan for later restoration of that borrowed surplus. The key is getting it restored.

Pricing Assumptions

MR. INGRAHAM: What is the relationship between pricing assumptions used in determining gross premiums and those used in setting dividend scales?

MR. STENSON: I think gross premium pricing functions should be based on long term projections taken with a very sour view. One should recognize the reality of the current experience levels, which should be the basis of the dividend scale assumption. Dividends, of course, can go up or can go down. They will go up, or should go up, if experience improves. They can go down to only zero if it worsens. But the gross premium must be adequate under even the gloomiest future scenario since profits in good years should largely be paid out. The gloom, however, should be tempered by the recognition that it is unlikely that every element in pricing assumptions: mortality, interest, expense, lapse, etc. is going to fall apart at the same time. Margins remaining in one are obviously available to help support a shortfall in another.

The current outlook is fairly straightforward. It has been alluded to by a number of people already. Interest rates may be subject to the greatest erosion in the long term, because of their relatively high level today. Inflation, which is in good part responsible for the relatively high level of interest rates, is going to put continued pressure on expense levels, although it also makes it easier to upgrade policy size.

The long term mortality prognosis is probably pretty good.

Another new item in the picture, however, is considerable competitive pressure for gross premium levels to go down and that has to be balanced in this context. One of the most significant movement in the industry in recent years has been the dramatic reduction in the gross premium per $1,000 for individual life insurance.

MR. INGRAHAM: Should not pricing assumptions for Ordinary participating insurance always be based on recent experience, with a trend projection to the midpoint of the expected duration of the current dividend scale?

MR. SUTTON: It is typical for par gross premiums to be set at a level which will be adequate under most adversity. While large companies might go through some of the tests that Dick mentioned, a smaller company might look at the general level of gross premiums in the industry. Such a comparison provides an insight into the degree of conservatism or optimism taken by a large number of other companies, and can serve as an indicator of maximum probable adversity.

Similar considerations would apply presumably to setting the maximum premium on changeable premium business. Then the charged premium on changeable premium business as well as dividend scales as Dick mentioned are developed based on current experience. The question is, "What exactly does current experience mean?" One of the things the Dividend Philosophy Committee had great difficulty in doing was trying to come to grips with what constitutes current experience. I certainly am not going to try to define it specifically. Current experience has more the flavor of contemporaneous than it does instantaneous. It is a time frame that is somewhere in between the historical past and the hypothetical future. It is neither water under the bridge nor crystal ball gazing, it is somewhere in between.

To develop new products, it is necessary to have short term projections of current experience or at least current experience as far as you know it. Those projections are more in the nature of extrapolations in which there is a relatively low level of individual judgment involved. Those extrapolations could reasonably be said to apply up to the middle of a period for which a particular dividend scale would be used. That is the sense in which extrapolation differs from forecasting or projection. With forecasting or projection, we would get into a different ball game. They involve a much larger degree of subjectivity and hypothesis about the future. But within that context, I would say that pricing assumptions for the dividend should be based on current experience. As you know, traditionally, dividends are a distribution of past gains, whereas premium changes are directed prospectively to cover future expected changes in experience. Unless we deviate from that principle for participating business, I think it is pretty clear that paid dividends should be based on current experience. Now you may ask how about illustrated dividends at the point of sale and I would refer you to Russ Jenson's paper. He talked in some depth about the alternatives; that is, basing illustrated dividends on past history or literally future forecasts of the current scale. And I believe that he and others have reached the conclusion that none of those alternatives is fully satisfactory, but the one that we have generally used is the "least worst." That is, the practice of using current scale dividends for the basis of illustrating the potential costs of policies at the point of sale is the best of available alternatives.

MR. STENSON: I would like to add one thing. It the financial year and the dividend year and the calendar year are all the same, the dividend liability, the dividends that you plan to pay in a subsequent year, will be set up as a liability or a charge in the annual statement for the previous year. So in that sense, they are very much current. The total dividend, in fact, is, by definition, paying out current earnings. I think this adds an element of currency to the need for developing factors that go into the scale in allocating the dividend to individual policyholders.

MR. INGRAHAM: What is meant by "recent company experience?" With respect to investment experience, is it the portfolio yield based on the book value of the asset portfolio or does it relate to "new money" yield rates and changes in the realizable value of assets? With respect to expenses, does it relate to actual company experience or trends?

MR. SNELL: There are really, under investment experience, two ways to go. You can use portfolio or you can use new money, and they are both good actuarial assumptions. Once you have made that decision, some of the other items follow. We happen to be a portfolio company. One of the reasons is that the trend is to have continued inflation which means more and more expenses or higher unit expenses with the mortality being very low. We think that if we were to use a new money rate, we would be reaching the point of decreasing dividends sooner than if we were to use a portfolio rate. However, the two systems can be used side by side. The problem is more the comparability of dividend illustrations and the fact that they are not comparable.

I believe that investment experience for the portfolio system should be based on current trends. To change it every three years, your rate book would be presumably based on your trend for maybe the middle of the three year period and so based on how you think your investments are going and the increase in portfolio rate or decrease, depending on the commitments you have made. Likewise with expenses. It, too, would be based on your trend of your expenses and not necessarily your actual expenses, but very close to it, because you do not want to change scales that often. If you are changing scales, and sometimes we try to change them every year, then you can be closer to doing it on a current basis.

For new money, you could base it on new money rates or your trend of new money rates. The problem here again is what are you going to do with expenses? Are you going to have expenses which are based on today's expenses, or are you going to assume that they will be increasing by duration? I like the discipline the current scale approach has and would like to have the expenses be based on the current expenses.

This has been mostly a discussion of the life insurance products. For deferred annuities more and more companies are using investment or new money rates to credit to annuities, but then likewise their expenses would be today's expenses, because that is what the current dividend scale is -- it is a discipline that we need to be sure that our illustrations are what we are actually paying.

MR. SUTTON: I would just like to make one comment about a line of reasoning that is interesting in thinking about what the use of a new money system means, as far as illustrated costs or illustrated dividends.

The first point to observe is that there would not be any reason for an investment year procedure without inflation. Inflation is the underlying element. Thus it is clear that a consistent approach would require recognition of inflation as it affects all elements of the pricing, not just interest, but expenses, or any other element that might be affected by inflation.

The next point to observe is that inflation really represents a rate of change. Then one might ask, why should that particular type of change be singled out for special treatment? Why not go the next step and consider rates of change in other elements such as mortality? This thought process could easily lead to the use of projections or forecasts rather than current experience.

MR. STENSON: I would like to comment briefly on that. I think Tom is implying that because of the link between inflation and interest rates, one is getting into an element of projection if one recognizes the current level of investment income in the dividend scale. I guess I just have to say that I would disagree with that thought, if the recognition of the current level of investment income is in terms of the current dividend scale, and its current effect as opposed to its projected effect. Indeed, the current effect of inflation on expenses is in current expenses as well. I think it then becomes a matter of disclosure, in terms of comparability of illustrations. I might add further that there are other techniques. My company, for instance, is using one that blocks together a series of policies, sort of a limited portfolio. In fact that is the definition that one of our Actuaries has used for our dividend technique. It seems to me that as long as the link is logical in terms of current experience and the illustrations and the disclousure, that is as reasonable and as logical a way to do it as any.

MR. INGRAHAM: Will the use of the investment year method with the ordinary line become more prevalent?

MR. STENSON: I would hope others would also comment, since I am with a company that is already using this type of approach in its dividend scale.

The current environment of high inflation and high interest, if continued -- and a lot of Actuaries and Economists think it is going to continue for some period of time -- would tend, I believe, to make the use of investment year approaches in dividends more prevalent. I think we are moving in that direction. A few years ago the Munson Committee Report indicated, in fact, this may have been more prevalent than had been realized in the past. As I commented before, I think if properly developed, they do address the problem of dealing with the high interest environment in a way which does justice to both old and new policyholders.

There are other related businesses, as well. We have been talking here about participating life insurance. A comment has been made that annuities are going very much in that direction within the industry. I do not know if we have many people here from stock companies, but the new concept of non-guaranteed premiums must have implications of this sort for them to think about. Certainly the whole question of dividend philosophy relates to some extent to that area as well.

MR. INGRAHAM: With respect to non-smoker discounts -- what decision criteria should be considered in evaluating whether or not to introduce a non-smoker price distinction?

a. Should they be made available for all plan/age/amount combinations? or

b. Should they be restricted to certain categories? and

c. Should they be made available only if additional Underwriting criteria are met?

This evaluation should be made in consideration of four basic areas: equity, competition, acceptability, and practicality.

The equity consideration relates to the credibility and mortality differences observed both in the general population and in State Mutual's and other studies of insurance mortality. An increasing number of companies have introduced non-smoker discounts indicating at least they feel that equity requires a separate rate classification. Equity considerations are also involved in deciding whether or not to restrict the discount to certain plan/age/amount combinations. At my company, our Board felt strongly that no restrictions should be imposed by plan or policy size. It should be noted that anything close to full recognition of the smoker/non-smoker mortality differences invites consideration of an unpleasant consequence. Theoretically, at least, the price to smokers should be increased. But there is not much evidence that this is actually being done.

Another issue relates to the ability of underwriters accurately to classify individuals and to verify the data. At my company, we essentially accept the non-smoker statement on the application and obtain inspection reports only on larger cases. A recent study we did of the protective information produced by our inspection reports revealed that only 2% of otherwise standard lives were misclassified as preferred risks because of their uncaught non-smoking misrepresentations.

The matter of any additional underwriting criteria is largely one of company philosophy. Many companies classify only according to the presence or absence of cigarette smoking within the past year. Others impose height/weight criteria as well, somewhat more restrictive than for standard lives generally. Still other companies impose additional criteria such as family histories, cholesterol levels, or even driving records. Clearly, the more the requirements, the deeper the discounts and the fewer the recipients.

A second question on this subject is: How should you treat the smoker who stops smoking after issue? Should you treat him as a reduction in rating case, and if not, what will be the effect on lapses and replacements?

If the ex-smoker had not smoked cigarettes for at least one year and was otherwise qualified standard, my company would prospectively reduce the premium to the preferred level. This approach is a logical extension of the special class rating structure, where conceptually the standard class is now really the first rated class. Not to do this may invite some lapses and replacements of permanent coverages, and it certainly will result in adverse policyholder relations with the ex-smokers.

A third question here is: What can be done for policies sold before the non-smoking discounts were available -- especially on term insurance? Should old policyholders replace their coverage if they are non-smokers? Should replacement commission rules be changed?

On these existing non-smoking, full term policies, the company may be well advised to make some kind of an original date exchange offer which would prospectively provide them with the preferred rates. This approach reflects the reality that these policyholders, if still insurable, have nothing to lose by replacing. Under the exchange procedure, future renewal commissions would be based on the reduced premiums for the balance of the original renewal period.

However, in the case of the existing non-smokers holding permanent policies, the exchange approach is not administratively feasible. Also, questions of equity emerge. The standard class for these existing policies was based on the blend of smokers and non-smokers, and rates were set accordingly. It can be argued that there is an implied contract with all such class members not to change the composition of the class subsequent to the time that the policies were issued in the class. To do otherwise, to allow the non-smokers in an existing class, otherwise standard, to benefit by way of, say, improved dividends would obviously have an adverse impact on the smokers in that class, who bought their policies when that risk classification was not being made -- in other words, when the classification rules were different.

Are companies doing anything about reflecting the many changing environmental factors into their pricing assumptions?

MR. SNELL: Experience is the result of the past. We must price for anticipated experience, up to a point. The changing roles of families cannot be ignored. We have not priced specifiallly for this, but have modified underwriting decisions periodically. Naturally, the pricing actuary must be involved when this occurs. Some examples are: in health, female and male laywers are priced the same. In life, is persistency affected by new life styles? Should there be after the fact pricing? Values on surrender should not be too high, but they should be fair.

MR. INGRAHAM: In the future design and pricing of long term coverages, what actions should companies consider to deal with the problems created by inflation?

MR. SNELL: As Dick said, we price for the future, we price with a recognition of what we think might happen and reflect the current experience. There is no question that in future designs we must deal with inflation. It is one of the overwhelming things that is with us. Inflation will mitigate in the future, but not go away.

On the other hand, for our whole life products that could be sold to a juvenile, that is a long time for a policy to be in force. We are reluctant to have guaranteed interest rates at 4.50% or 5.50%. We run asset shares under several assumptions, such as: If we did have 4.50% it is good. But let us assume we had a split interest rate of maybe 4.50%, for ten years and then it dropped to a 3.50% rate that we think would additionally be more apt to be earned by the company during the lifetime of those policies. After we have developed these asset shares, and this includes how we think expenses will be in the future, we try to develop a pricing formula that would duplicate them on only one interest rate to simplify the overall development of the cash values. But we are building into our gross premium margins for the interest rate to drop from its current levels.

One of the big problems of any change in premiums, because they are going down, is compensation. The agent must live. We must find ways to make him more productive, there must be ways where he is able to earn a good living or we will not have anyone to sell our products. Since time is his main commodity, we have to be able to develop techniques for him to be able to sell as much insurance as possible in the time he has. I am sure all of you are going to doctors, and you see the same problem there when you pay the doctor bill. The doctor has only so many hours in the week in which he works and in order to keep up with inflation, he has to increase his fees in order to cover his costs.

I think one of the things we would like to see agents do more of is be out there selling, providing more support and service from the home office. We must try to convince our policyowners that they do mean something to the company, that we do want to service their policies after they buy from us. They are not just a number, even though we are using computers to keep costs down. We do like to have that renewal premium income continue.

MR. INGRAHAM: What is the proper balance of price, profitability and agent's compensation in products of the future?

MR. STENSON: Ultimately, this will be determined by the market. The problem is to guess right ahead of time. Let me start by working backwards from agent's compensation. This is one of the most important ingredients of a product's price and profit margin.

There is a lot of natural inertia in the relative level of commissions paid to agents. The current pattern of high initial commission, followed by a lower renewal rate, sets up a large group of people who not only expect that pattern, but who are budgeting and planning their own personal financial lives in harmony with it. There has been some discussion of more level commission patterns lately, and this certainly has an appeal in terms of enhancing profitability and responding perhaps to some industry critics. But a way would have to be found to help agents bridge this change, especially newer agents with lower or non-existent renewal accounts. If agents cannot make a living with this sort of pattern they will not be able to sell at all and the profitability of the product in fact will not be enhanced.

Notwithstanding all these problems, I would not be surprised to see some movement in the future towards more level commission patterns. I also think the question of equalizing term and permanent commissions will have to be looked at closely by companies. I do think, though, that life insurance selling is largely going to continue for some time to come to be on a commission basis, not on a salary compensation basis; and as a corollary, I would expect to see the ingredient of the price for aggregate compensation remain somewhere around current levels. Any additional profitability from sharply reducing such compensation levels is not going to produce any reduction in price unless a way is found to continue the sale of the product. The converse of that, of course, is that if ways are found to effectively market at lower unit agency compensation, then companies which continue on higher compensation levels will not be competitive. But on balance in the immediate future, I think it is going to stay roughly at the current aggregate level.

Concerning price, I really commented earlier on other items in that I think continuing pressure on the gross premium price is going to be with us for some time to come. Mortality improvements can go only so far. Inflation is the problem. Since I do not see much leverage in terms of agency compensation, it implies continued pressure to achieve other marketing and administrative efficiencies, which is not an easy task in an inflationary environment.

Profitability completes the equation and obviously must be preserved. Some of us have been talking about needing less surplus in the future. If the products of the future are faced with continued pressure on price, though, there may be an additional element of risk to be concerned about.

MR. INGRAHAM: As competition becomes increasingly acute, what steps can be taken by a company from an organizational, informational, or otherwise standpoint, to avoid placing the pricing actuary in an impossible situation -- in other words, between marketing survival pressures and the actuary's concerns regarding equitable treatment and professional standards. And by the way, the answer -- "Make him president," is unacceptable.

MR. SUTTON: We have to recognize that the competitive environment is part of the real world and we cannot use professionalism as a shiled to hide behind. No matter what we do, every action that we take, or for that matter, actions that we do not take, are subject to criticism by someone. If we need a criterion, a better one might be this -- "If this action is held up to public scrutiny, will I still feel that it is what I should have done and how I should have done it?" That criterion is not whether there will be critism. If just says that after the inevitable criticism comes, will I still think that I did the best that I could, and that I did the right thing of considering the alternatives that were then available.

Now while that approach may give you a little comfort, there are still some things that you might do in a company to help the situation. One of those, organizationally, is separating the function of new business product and dividend scale development from the function of setting existing dividend scales. This separation requires a fairly large company and may result in inconsistencies merely because different people are trying to attempt the same thing. It would certainly be unacceptable to have initial dividend scales that were out of line with existing ones and only corrected over time by another department. So clearly there would have to be strong coordination. But at least that sets up two knowledgeable professional people who can argue with each other about the issues on the same level. That might be helpful.

Another potential helpful step would be to have clearly visible and easily understood information that is communicated to top management. An actuary's report, while it might be precise and detailed, might not be easily understandable, and so other means to accomplish this are necessary. A possibility is simply taking the ratio of dividends to gain before dividends for different blocks of business. That may be an eyeopener, but in doing this it is necessary to adjust for the amortization of acquisition expense in determining the gains. But having done that, those ratios might provide a very simple way to communicate to top management the relative amount of gains from blocks that are being distributed back to those blocks.

Another alternative is to obtain an outside opinion. That is a common practice for valuation of liabilities. But only a few companies do it for dividends. In part, one reason is that the valuation of liabilities is much more straightforward. It is not necessary to have detailed knowledge of the internal operation of the company and its history of products. But nevertheless, it is possible to have an outside opinion while spending a reasonable consulting fee on it.

MR. INGRAHAM: Will exchange, or update, offers become prevalent? Will they serve as a better means to identify and correct inter-generational inequities?

MR. SNELL: The work in undertaking an update offer is enormous. Consequently, the gains to the policyowners must likewise be large. Certainly our update program that we are currently undertaking in which we are changing the interest rate on in-force policies from the contractual rate at time of issue to a 4% interest rate took at least 15 years of exploration on an on-and-off-again basis and then two years of heavy concentration, including programming to do the job. This included state approval by the regulators before we could start this April. However, the gains in that area are more than enough to justify the cost involved. Those situations do not occur very often. Consequently, I think that this is not something that you will see that frequently.

For one thing, a life insurance company must have good persistency and a lot of business that has been in force for many years for them to consider something of this sort. Many companies fall into that category, and they are the ones that would be looking at this. You need a proper change in the economy to make an offer of this sort worthwhile. If the interest rates had stayed at 3%, we would not be making the offer today. If our earned interest rates or portfolio earned interest rate was in an area of 4%-4.5% we would not be making the offer today. But as the earned interest rate became larger and guaranteed interest rates that we could use became larger, so that the spread increased and the taxes that we paid became larger, we could easily justify the cost of an update program.

It is very possible in the future that if dynamic interest rates come into play, that something of that sort hopefully could be written into the contract that would permit one to have, in effect, an almost automatic update without having to make an offer. I do thing this does improve equity between generations. You, Harold, commented earlier on your non-smokers policies, in that you do make offers on the term policies so that they can have the non-smoker's rate. This provides a better equity between generations of policyowners.

On update programs I think it is important to distinguish between those that clearly benefit all of the policyowners. With Northwestern, it is basically a technical change to a 4% valuation basis that provides a more favorable federal income tax treatment. But these are changes that result in no worsening of cost to any block of policyowners.

However, there are other types of update programs, such as moving people who are non-smokers to a better rate, that clearly have a disadvantage for those who remain. I think it is important to make that distinction and to raise the question of whether a company which actively encourages internal updating is subject to criticism for inequity. It clearly would be subject to criticism. The question is whether the criticism is justified or not.

MR. INGRAHAM: Consider the following factors: Federal income tax laws, policy loan provisions, flexibility, valuation and non-forfeiture laws, disclosure requirements. What do you think the likely future characteristics of these factors will be? Do you think the picture is likely to be good for the industry and what can the industry do to improve the picture?

MR. STENSON: Let me take these very briefly one at a time. On Federal Income Tax Law, the current law is placing considerable pressure on the industry, as we all know, because of the increasing tax load associated with the higher investment returns of today. The future picture I think is not really clear at this particular point in time. There are many competing and dissimilar interests within and without the industry, and any kind of major tax issue is bound ultimately to be settled in a politically charged environment. I'm not sure what the industry can do about this other than to try to work slowly and steadily toward a representative viewpoint for all. There are other things of course that can be done within the current tax law, and one is higher valuation interest standards. Of course, that is a prospective solution only, except for applications such as Northwestern Mutual's "update program."

Policy loan flexibility -- I think we have had tremendous arguments for flexibility in policy loan interest rates for many, many years, and basically we have not progressed very far. You could say 5% to 8% is a very big change, and I guess it is. But what flexibility we have is limited to 8% in almost all states and there are a few states who are not quite yet past 6%. Some of our own agent groups may not be happy with complete flexibility and may not be happy with increases in the rate. My personal view is that the picture is not too good on this problem. We do have a current situation where, because of the economic environment and high interest rates, we have some of our best arguments in years in terms of the pressure it places on the industry and the inequity between policyholder groups that it raises. The problem I see is impressing these successfully in every state.

Valuation and non-forfeiture laws -- here I am much more optimistic. We do have some really new, fresh, thinking going on, in terms of the dynamic proposals that are currently underway. We are dealing with an area where the profession and the industry have had an opportunity to provide meaningful input and I believe that these proposals should be pressed generally.

As to disclosure requirements, it is my hope that they will continue to be the province of the state. The NAIC model disclosure regulation is a good one. I think it will undergo some evolutionary process. There is a lot of discussion going on now about some form of disclosure, with the application, even for companies offering a 10 day free look. It does, of course, have problems in that the final disclosure form will include all of the details of how the policy was in fact issued, what the underwriting classification was, and what additional benefits were included; and it is impossible to know that until in fact all the action is completed. It is possible, though, that some form may have to be adjusted to it.

Adequate disclosure at the point of sale, I think, helps the industry. We need to be sure to press for material that gives a balanced and reasonable view. I believe we should continue to argue against the FTC style rate of return disclosure proposals. These, I believe, represent more a point of view than a disclosure and cost comparison aid.

MR. WALTER MILLER: On projections, I agree with Tom that it is possible to construct intricate and very well reasoned and very logical chains of logic and deductions that would justify the use, or give you guidelines for, the use of projections and dividend scale construction. But, please, let us not do it. We have heard a few references this morning to the discipline of the current assumption approach, and that is really there. I think that all of the logic and reasoning that you can build into something associated with projections is great from a theoretical standpoint, but then let us put ourselves back in the real world. Isn't it really true that all we would be doing is putting probably intolerable pressures on ourselves to come out with what in the end might be some fairly romantic items and romantic looking scales because of competitive pressures? Why should we self-inflict that sort of wound?

Harold, on the points you made about ex-smokers, I would just hope that we might remember that sometimes people become ex-smokers because they have gotten emphysema from smoking too long.

On the subject of leveling commissions, I think that one of the greatest misconceptions that consumerists have, and that they talk a lot about, is that when they start talking with a great sneer in their voice about the front end load, I think they feel that perhaps the so-called front end load is the root of an awful lot of evil and bad things that policyowners and the public are subjected to. I think they believe that, if compensation for life insurance could be leveled out, that this would produce a dramatic decrease in the long term cost of permanent insurance policies. Now that is just not really true, as long as you are a company that develops reasonable experiences. By reasonable, I would say any thing in the 15% area or less in terms of first year lapses, with renewal lapse rates scaling off from that point. For those of you who haven't done the calculation, you will find that if you have relatively low lapse rates in that area you can level out compensation. In fact, you can flatten it out completely and it really won't produce very much downward effect at all on long term pricing. It will allow you to raise early year cash values somewhat but that is all. That is something that I would hope that all of us would try to do a little educational job on -- the consumerist people and the press, policyowners, and others who really don't appreciate that very important fact.

Now, a question -- Help me please. I, like most other people in this room, have responsibility for pricing life insurance products for mutual life insurance companies. One thing that I, we, see all around us is another downward price spiral, a real price war on term insurance. The prices of non-par term have taken another significant downward dive in recent times. What do we do? The question really is to what extent, if any, can, should, a mutual company push its term prices down to levels approximating those now offered by non-par companies, and if we do, how do we justify it in terms of concepts of equity in a mutual company?

MR. SNELL: I do not believe we want to get into a price war with non-par companies or with any mutual companies. I am sure a price war in the long run is going to destroy all of us. At Northwestern Mutual we realize that term insurance is very important. It constitutes a good segment of our business, but I think the agents sell on the concept that term insurance is going to be converted and it is a term plus a conversion to a permanent plan. A lot of the companies with low term rates do not have a good permanent plan to offer. On the other hand, we cannot be out of the ball park. If we are out in left field we will not get past the door. So we do have to be reasonably close, but we try not to be out in front.

MR. INGRAHAM: I am speaking of this in the perspective of a company that dramatically did reduce term costs as it introduced the smoker/non-smoker price distinction. My own personal feeling is that that is about the last reduction of its kind we are likely to make. I personally believe that we are about at the low bending point of pricing for term because I happen to think that expenses are going to rise considerably in the 1980's.

I think we may be slowly coming to the painful realization that, like the rest of the world where the cost of goods and services are going up (with rare exceptions), the cost of term insurance in a well managed company may indeed also have to go up. I don't think I want to be a party to pricing a term product which cannot be expected to support itself.

MR. PHILLIP SHORE: I have a question for Bill Snell and I'm afraid it is going to reveal how long it has been since I was really hands-on pricing products, but I'll plow ahead anyway.

At one point I heard you say that you were concerned over long-term guarantees of interest rates of say about 4.5%, that you like to try to build into your pricing something that allowed some margins later on in the interest rates you were using in your pricing, and that is the way I see it too. But then I heard you saying that maybe with some of the dynamic interest rates and so on we might actually build in the possibility of guaranteeing much higher rates in the future through a project update type of arrangement, and I know at this point you are running the risk of guaranteeing 4% on all of your policies for the next 50 years. Did you really mean that you wouldn't mind seeing another project update that would raise that to 5% or 6%, and how does that tie into not wanting to guarantee long term interest rates in your pricing? Where am I missing the connecting link there?

MR. SNELL: I did not explain my comment clearly enough on dynamic. What I was thinking is that you could, and this is not currently available under regulatory laws, have a contract that is issued at say 5.50% for 10 years, dropping to 3% thereafter. However, at the end of 10 years, if new issues are at 5.50% it will continue at 5.50% for another 10 years. There will be an automatic check point every 10 years. That, I think, would be more of an automatic update. But in the pricing that we have done at Northwestern, we assume in our asset share calculations a dual interest rate, although the final product is based on only one.

Dividend Philosophy

MR. INGRAHAM: The Society of Actuaries for some time has had a Committee on Dividend Philosophy and the Academy of Actuaries on Committee on Dividend Principles and Practices. We have the benefit of Tom Sutton's involvement and expertise with respect to these committees, and Tom now is going to tell us where this Dividend Philosophy Committee Report currently stands.

MR. SUTTON: The work of the Society's Committee on Dividend Philosophy has been described in two reports by the Committee and in concurrent sessions held at each of the last annual meetings, so I certainly don't plan to recite that history and background again today, but it is there and available if you want to read it.

The most recent report which was discussed last October put forth a set of recommendations concerning actuarial principles in connection with dividend determination and illustrations. Those recommendations were then up to the seventh draft, and they represented the efforts of the Committee to focus on professional responsibilities of the Actuary with respect to dividends. That approach appears to have the most potential as a fruitful way of addressing the issues which gave rise to the Committee's formation. The purpose of last October's session was to elicit reactions from Society members so that suitable modifications could be made to those recommendations. There were some reactions but not really a large number.

Just to remind you again about the division of labor on this task, it is the Society's function to address the actuarial principles involved in dividend determination and to perform any necessary research and development. However, it is the job of the two national organizations, that is, the Canadian Institute and the American Academy, to incorporate the recommendations into guides to conduct and to take any other steps believed necessary to properly implement standards of practice in the two countries.

Since last October the Society Committee has made a number of modifications in their recommendations and just a month ago turned over to the Academy the eleventh draft. Some of the areas discussed or changed were these:

- Stock company business
- Deferred annuities
- Non-guaranteed elements other than dividends
- Class placement criteria
- Termination dividends
- Level of detail appropriate for the actuarial report

On the stock company question, Draft 11 is not siginifcantly differnet from Draft 7. You may recall that the Committee is working on a questionnaire to be sent to stock companies. The questions are designed to elicit information on principles and practices which the Committee can use as a basis for proceeding. The questionnaire is expected to be distributed this month, at least that is the last that I have heard, and the plan is to compile the data in sufficient time for the Committee to draw some conclusions early in the Fall.

Deferred annuities of the traditional type don't present any particular difficulties with respect to the recommendations. However, traditional annuities are now sold only by a few companies and the block of such business in force is probably declining.

Of more importance are the flexible premium, new money annuities introduced by many companies over the last few years. Those annuities often have non-traditional structures and may provide for excess interest instead of dividends, per se. Sometimes it is difficult to tell a par and a non-par annuity apart without looking at the brief description on the cover of the policy. For that reason, the Committee feels that consideration of deferred annuities should be integrated with treatment of par business of stock companies.

The third item on my list that I mentioned was non-guaranteed benefits other than dividends. The two most interesting examples of those are changeable premiums and excess interest. Changeable premiums are primarily a stock company innovation for non-par insurance, although there is at least one mutual company that has a par product with changeable premiums, and excess interest is mainly used with deferred annuities. So that item also was packaged with the previous two for further studies this Fall.

The class placement criteria in Draft 7 was very long, complex, and conceptually difficult to grasp. In Draft 11 the criteria is more simply stated and it is this: "The placement of a policy within one experience factor class or another should be based on uniformly applied criteria designed to group together policies with similar levels of exerpience. In regard to claims factor classes, the actual occurrance or non-occurrance of a claim on a particular policy should not be a criteria for class placement of that policy." This new criteria obviously provides much greater latitude than the Draft 7 version.

Termination dividends were studied in some detail. Practices of seven or eight dozen companies were examined. Consideration was given to setting forth numerical tests of suitability. Walter Miller suggested at least a couple of those. However, it was decided that in a document whose purpose is to state principles that such a numerical test would be inappropriate. The Committee did recognize the existence of more than one theoretical basis for termination dividends by moving from a statement that termination dividends represent the release of previously accumulated surplus to the statement that they represent the release of amounts previously accumulated.

Finally, there was considerable discussion concerning the level of detail appropriate for inclusion in the Actuary's Report. For example, it was questioned whether the report should include a description of the exact relationship of experience factors to actual company experience. At present, the Committee feels that that level of detail is not necessary.

While the Society Committee was refining the recommendations, the Academy Committee was preparing its report and conclusions which were submitted to the Academy Board on June fourth. As a result the Academy Committee has obtained approval to expose its report to the Academy membership. This report is expected to be released this summer. The slightly modified version of the Draft 11 recommendations is included in the Academy Report as well as two other items developed by the Academy Committee. One is a sample of a possible actuarial statement concerning dividends which was designed to provide regulatory disclosure as a part of the annual statement. The second is a sample of possible changes in consumer disclosure which could be incorporated in the buyer's guide with the objective of making a more understandable statement with regard to the nature of dividends on participating insurance and also with the view of pointing out some particular difficulties that might have been made visible by the Schedule M disclosure or as a regulatory disclosure.

MR. INGRAHAM: Tom, you mentioned termination dividends. In today's world, what do they really represent and what guidelines as to the time of emergence and size of termination dividends should be set forth in this report?

MR. SUTTON; I don't think that the nature of termination dividends is completely clear. Some of the very large companies have a very well defined, consistent theory under which termination dividends do in fact represent a release of a portion of previously accumulated net surplus or true statutory earnings. For other companies, it seems quite apparent that they represent a release of other amounts, that is, amounts that have in some sense been deliberately withheld from annual dividends which would otherwise have been payable. I have heard a number of companies remark that they don't break even on an asset share, until some time in the 20th, 25th year, or even later. Some of those same companies start paying termination dividends prior to the 15th year. So I would suggest that clearly they can't represent in a traditional sense a release of previously accumulated net statutory surplus. There must be some other theory behind them, and one possibility, of course, is this holding back on annual dividends in order to accumulate amounts to be used as termination dividends. One can set forth legitimate reasons for doing so. In fact even in McClain & Marshall that approach was described as a means of developing termination dividends and justifying their size.

Walt, would you like to talk about some of the numberical tests that you came up with emperically.

MR. MILLER: I can understand why the Committee acted as they did and decided that it was inappropriate to have such specific numerical guidelines or tests or standards for termination dividends in a document of this nature. It raises the question -- if you have standards for this item, what about all of the other related items that you can think of? Some of you have heard me speak before on the whole subject of professional activity in the area of developing professional standards for dividend principle practices. Some of you have heard me say that I think it is critically important for the profession to move and to move quickly. Because if we don't, we will be leaving a vacuum that will be filled and it will be filled by people and by concepts that we would rather not have there, and it would be another very large self-inflicted wound if we fail to act and to act quickly.

I'm sure that when the report of the Academy Committee is released for exposure, as it will be soon, that it will be attacked on both sides. I'm sure that there are going to be some company people who are going to say "This is terrible, how can this Committee suggest disclosing some of our secrets on how we determine dividend scales like this?" We'll be attacked by others who will say just as predicted all along, the actuarial profession has come up with a massive cover up and the only way to really protect the public is to give regulators and college professors the right to dig into each and every document that accompany producers in the course of the dividend scale determination. I hope that most people will agree that the Academy Committee has come up with a reasonable and in fact necessary course of action.

Getting back to termination dividends, just peruse any industry publication and you still see termination dividend scales that are payable on surrender but they are not payable on death, and you see termination dividend scales that are zero for nine years and $15 from the 10th to the 19th year and $25 for the 20th year and subsequent. My proposal that somewhere, somehow, we find the right way to fit into our structure some specific standards, some specific numerical standard for acceptability of termination dividends. The abuses were so visible. Can it really be heard, can it really be difficult, isn't it really right for us to recognize that and say, "Hey, here are some reasonable standards as to when termination dividends might emerge and as to how big they might be when they first start to emerge." That was all it was and I hope it appears in the proper context.

MR. SNELL: I have not looked back at the material recently, but I know that the New York Insurance Department had a hearing many years ago on termination dividends, and some of the guidelines that we must now follow in the state of New York came out of that hearing. I wonder if there is anything in that material that would cover the point you mentioned, Walt, because the terminal dividend must bear a reasonable relationship to the sum of the annual dividends. They insisted that termination dividends be available for policy lapses, or paid up, and that came out of that hearing. These guidelines could be used as a starting point, but I do agree with your comment.

MR. INGRAHAM: Section 5.6 of the Report, addresses two different questions. (1) Does this section permit the variation of dividends to a particular policyholder according to the degree of policy loan utilization engaged in by the policyholder? (2) How does this section address the "implied contract" issue, with respect to, say, 5% or 6% loan rate policyholders who take advantage of 8% loan rate exchange offers, thus moving to a different class and leaving behind a class with a higher concentration of borrowers?

MR. SUTTON: The placement of a policy within one class or another should be based on uniformly applied criteria designed to group together policies with similar levels of experience. That statement alone would not preclude direct recognition of policy loans. In regard to claim factor classes, it was not the intention of the committee to interpret policy loans as a claim. If you recall the prior statement, which was considerably more convoluted, it would have precluded direct recognition unless the policy language itself indicated that direct recognition would be made. It may have required several readings of the paragraphs in order to make that interpretation, but I think that that was the intended interpretation. It was based on the premise that class shouldn't change after issue due to an event occurring after issue. For example, if you identified state of residence at issue and for some reason or other at a later point in time you wanted to introduce a distinction in dividends between policies issued in one state and those issued in another, that practice would be consistent with the principle as it was previously stated. But in contrast, the principle would not permit a different classification because of current state of residence. Drastically different tax treatments in different geographical jurisdictions could not be recognized directly by introducing a distinction in dividend classes on the basis of current residence. This example, in particular, caused the committee to reconsider, and eventually the best approach that emerged was to provide a statement of criteria that is fairly clear, and is fairly open, even though it might still be subject to critism.

Concerning the committee's work in general, it is easy to predict two main types of criticism: One is that the document itself is so loose that it is ineffective; and the other is that the document will result in a forced massive change of practice. We hope the real results will lie well within these two extremes.

MR. INGRAHAM: Is there any merit in incorporating a requirement in this report that expense factors used in the determination of dividends for each block of business should be determined in such a manner that when the individual components are added for all policies the result is a reasonably close approximation of the appropriate annual statement figures?

MR. SUTTON: I can see the desirability of a criterion like that, but if carried to an extreme a very recent company would be unable to satisfy it. It also raises anew the question of accounting practice and the amortization of acquisition expense. So I think that merely incorporating such a statement in a document like this would not lead to clear-cut results. Some large mutual company actuaries might tend to interpret such a requirement as relating to statutory accounting, while others might interpret it with respect to some amortization procedure for acquisition expense. Because of that possible dichotomy, and because of the other areas of slipperiness, such as allocation of expense, it did not seem useful to include such a criterion.

MR. ROBERT LOWDEN: My question ties together both the pricing section and the dividend philosophy section of this presentation. I understand that we are under no obligation to pay our illustrated dividends, but I have grown up in a period of time where I think myself and my predecessors were fairly confident that the scale they put forth would be payable. We had better than a wash in most cases. As we now get the pressure of competition in these other things, the policy loan problems are coming in. We get more and more of our assets out on loan. I have no doubt expenses will continue to go up. I have a lot of questions as to whether or not the interest will offset them and I set here quite concerned whether we will be able to pay our scales that we are not going to illustrate. I wonder if any one shares this discomfort with me. I think our people have come to expect these scales despite the caveat in all our little illustrations.

MR. STENSON: Certainly customers are not going to be happy if they get a dividend considerably less than the dividend that has been illustrated. That is a fact of life that we have to worry about and be concerned about. On the other hand, if you're pricing a dividend scale on current assumptions and current experience in fact the current experience worsens to the extent that you cannot pay the dividend, there will be no alternative but that the dividend will have to go down to a lower level. We'll have to learn how to answer letters. I think the ultimate test of this is going to be a reasonable man or woman kind of approach to life. Maybe I'm being naive, but it seems to me that if the dividends have moved in such a way as might be expected, relative to the experience, that people live in a business environment and an economic environment where they know that something of that sort has to happen. If they are getting 3% interest in their savings bank for instance, and you tell them their dividend is lower because interest rates are quite a bit lower than when they bought their policy, I think that is a reasonable statement to be made. Indeed, if savings banks are paying 3% at some time in the future there is not a single company in the business that isn't going to be paying considerably lower dividends then were originally illustrated.

MR. MILLER: To go back to the real world, I think this is something we must pay particular attention to, and Bob, I certainly share your worry and discomfort. Maybe it is not so much the public, but our field forces. We have taken some dividend actions occasionally in times past that have gone relatively unnoticed among our policyowners but have raised a bit of a storm among our agents -- "My God how can we do that?" -- if we do that then the Northwestern Mutual agents will be able to point to the fact that we did that and get great competitive advantages.

MR. SNELL: Walt, it is worse than that, because you have now a lot of companies like yours and mine preparing computerized illustrations which assume that outlays in the future are based on a continuation of scale. That puts the phrase I've used today, "the implied contract" conception, in the minds of the field and probably in some of their customers. They may come to the conclusion, woefully, that it is better to grandfather the existing scale if they can justify it with the emergence of some future experience factor mix that in the long run there is going to be some kind of a crossover and out there ten or twelve durations there will be a balance, where they have overpaid dividends in the next few years and they have underpaid dividends in the next few years after that. Well, that is a dangerous approach and it does not achieve total equity because of the distribution of the policyholders who quit early or for the policyholders who stay later. One other side of this is what do you think companies are going to do with respect to 5% loan rate business? Some of those closed blocks where the proportion of the cash value that is borrowed is now up to 50% and even 60%. Do you think we must start decreasing dividends? I think that we have to get the message to our agents that they should expect this. I can remember in 1949 when we had a decrease in dividends on our American Experience business. We had pre-printed letters that we would send out to everyone who wrote in who wondered why their dividend went down. That wasn't just a case of writing them, but the fact that we had to pre-print replies indicates the problem we could be faced with. I cannot see much increase in dividends for those policyowners with a 5% loan rate. You look at your after tax yield on policies which are almost fully borrowed, and it is down to about 4.2% depending on what your federal income tax is, but that is about where we are in our company. If you are providing a higher dividend than that, I think those policyowners are getting very close to the time when their dividends are going to start decreasing by duration, or, at best, staying level.