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THE FEDERAL TRADE COMMISSION (FTC) REPORT

Moderator: THOMAS F. EASON. Panelists: RICHARD V. MINCK, LOUIS GARFIN, WALTER N. MILLER

1. What is it?

2. What is good about it?

3. What is bad about it?

4. What has been its effect on sales? What will be its effect?

5. What has been the industry response?

6. What will be the eventual impact on legislation or regulation?

MR. THOMAS F. EASON: My personal view of the FTC report is that of an indignant professional. The papers I authored are titled "FTC Fools The Citizens" and the "The Whole Life Contract." These were authored to restore a balanced point of view for my company's field force after the imbalance created by the sensational press accounts of the report after its release last summer.

I will leave technical discussion to others. Most of my brief remarks now are taken from a recent address to the Nebraska Actuaries Club, a forum which included a presentation by Mr. Mike Lynch, Chief Economist of the FTC and a primary achitect of the report. The Congressional Record for November 14, 1979 includes strong language authored by Douglas Bereuter, Congressman from Nebraska.

"I can think of few federal agencies that rival the FTC in their ability to arouse both genuine concern and downright outrage on the part of my constituents. If it is true that the FTC has become the focal point for critics of government over-regulation, then I can think of no federal agency that deserves it more... whether it is funeral directors, life insurance salesmen, the cereal industry, or used car dealers, the story is the same over and over again. The heavy-handed, arbitrary, arrogant manner by which this agency and its staff pursue a mission makes one wonder whether the charter for the agency should be extended..."

This is strong language. If you have seen the wave of misleading press reports, have counselled with insurance sales people, have attended meetings in Washington and elsewhere as I have, you would find substantial basis for this degree of discontent. Mr. Minck will no doubt update us on the recent congressional activities dealing with legislative veto of administrative rule-making activities. I find this turn of events both gratifying and frustrating, gratifying in that it promises some relief, frutrating in that our system of government functions best when it is not at war with itself.

I hope this audience does not find my political observations annoying or inappropriate. I do want you to know that my activities outside of company hours have been dominated this past year by active involvement in the political process. Too few actuaries have stretched their time and intellect to grapple with the daily eductional and decision making process of local and national government. As you consider the balance of this presentation today, I ask that you view it as something more than a technical review of a government report. Consider the discussion you hear as a clear-cut example of the impact which government has today on the future ability of private insurance enterprises to serve the needs of our citizens. Involvement of actuaries in the arena of politics is a challenge I commend to you. Encouragement of swift and forceful objections, when they are warranted by people trained in our profession, is essential. As future reports and comments from a variety of sources come to your attention, please respond.

Those actuaries with management responsibility outside of the technical area bear a particularly heavy burden. When the choice of filing a document or writing about it comes up, I hope you will choose deeper involvement.

I turn now to the other members of the panel for their discussion. Messrs. Minck, Garkin, and Miller, the platform is yours.

MR. RICHARD V. MINCK: In my remarks this morning I intend to try to provide a brief background on the history of the investigation by the FTC staff. I will spend some time on the calculation by the FTC staff of the "aggregate rate of return" for the industry of 1.3 percent. Finally, I'll share some speculations on where we might be going in the way of regulatory activity.

I. <u>BACKGROUND</u>

On December 15, 1976, the FTC announced a staff investigation to determine whether adequate cost information was being provided to prospective life insurance purchasers. It was apparent at the outset that the staff had determined otherwise, and that the staff intended to present permanent life insurance policies in the most unfavorable possible light by (1) using cost indexes that would split them into "savings" and "protection" and (2) using very low assumed term insurance rates that would result in a very low "rate of return" being reported on the savings element. The announcement of this investigation occurred just shortly after the NAIC had completed its own investigation, encompassing over four years of effort and culminating with the adoption of a model regulation to be enacted by the states.

In spite of the apparent FTC staff repudiation of the NAIC model, and in spite of the very clear evidence that the FTC staff had prejudged the matter, the industry offered whatever assistance it could to the Federal Trade Commission. I know we tried to inject some objectivity into an otherwise close-minded atmosphere. In May, 1978, leaders of the business met with the Chairman of the FTC to express concern over the course of the investigation and to urge that the business be given an opportunity to present its case to the commission before any report was either adopted or released. In spite of this, the staff report was released with no opportunity for state regulators or for the business to comment. The report seemed to indicate that the staff had mostly worked to justify the conclusions reached at the outset of its investigation.

During this period of time, the FTC commissioned two research projects, one by Professor Jacob Jacoby of Prudue University, and one by Professor Roger Formisano of the University of Wisconsin. The results of those studies were not conclusive. As witness to this fact, both the industry and the FTC cited those studies to support their diametrically opposed conclusions. It seems clear that the staff of the FTC was not completely satisfied with the results of this research. For instance, the Jacoby research (which cost a quarter of a million dollars) was only mentioned in a footnote and briefly summarized in an appendix. You might contrast this with the prominence that the FTC gave that research in letters written to Congressmen and state insurance departments before the report was done. In each case it was cited as a major reason for the states not to adopt the NAIC model regulation.

The FTC staff seems to have concluded that there is a need for federal regulation in the insurance business and that cost disclosure is the proper way to achieve it. As early as 1977 they apparently intended to promulgate a Trade Regulation Rule on cost disclosure. In 1978 the FTC budget request contained a request for funds for at least one and possibly two Trade Regulation Rules on cost disclosure to be proposed during that year. The budget, however, was approved only after Congress received assurances from the Chairman of the FTC that "contrary to its earlier plans the FTC no longer contemplated the initiation of Trade Regulation Rule proceedings on the subject of cost disclosure in the fiscal year 1979, but rather would seek to encourage meaningful regulation in this area at the state level."

Well, we were not surprised that the report released on July 10, 1979 by the FTC staff was critical of the business, the whole life insurance contract, and the NAIC and its model regulations. We were surprised that a report of such length, that had been so long in the making, had very little in the way of new information or suggestions. Their new form of cost disclosure was the Linton Yield method which Albert Linton had devised for a speech to the NALU in the 1920's. We were also not surprised by the manner in which the report was released because it was a technique they had used before. They sent reports to the press, about a week in advance of their appearance before Congress, with an embargo on it. Senator Cannon, Chairman of the Senate Committee on Commerce, Science and Transportation, commented on that at a hearing in September: I will quote him, "Most disturbing to me is the way in which the FTC attempted to sell its report to the press without first giving the industry the opportunity to review and comment on the report."

The FTC had generated a series of complaints from many businesses about the ways in which the FTC had conducted its various operations. Since the FTC is an arm of Congress, the Commerce Committee of the Senate and the corresponding House Committee had introduced legislation to make it more responsive to the intent of Congress. The Appropriations bill signed into law in late May included a provision that any regulation of the FTC could be vetoed by the two houses of Congress. That would not prevent the situtation we just experienced, where they were not issuing a regulation but were simply doing a study, writing a report, and trying us in the newspapers. So the Appropriations bill also included a provision that said they could not investigate the insurance business without being specifically requested to do so by one of the two congressional Commerce Committees.

Some lawyers have the viewpoint that the McCarran-Ferguson Act took away from the FTC any authority to regulate the insurance business and, therefore, the FTC had no reason or authority to investigate it. If you accept that viewpoint, then what happened with the current legislation served merely to clarify the existing law. Though this sounds like a modest triumph, as a practical matter it seems to have had quite a profound affect on the schedule of activity of the FTC staff. The unit that had been working full-time on insurance is in the process of being reassigned to other items. It had about 20 additional investigations on its list, but most of those have been shelved.

The impression around Washington is that the history of the last year is causing the FTC to reexamine its methods, and that in the future it may use methods that are more normally used by other government agencies. However, it will take some time before we know whether it will change.

II. INDUSTRYWIDE RATE OF RETURN

The portion of the FTC report that attracted the greatest attention in the press was the claim that the industry as a whole paid 1.3% as a rate of return for the year 1977 on its ordinary life insurance business. This claim, and the calculation that supported it, had nothing to do with either disclosure or cost comparision which were really the subject of the report. I think it was developed simply to create headlines, and to establish the idea that life insurance companies were cheating their customers by crediting an outrageously low "rate of return" on their contracts and by successfully hiding that "fact" by writing such a complex and obsecure type of contract.

Let me describe the calculation made by the FTC staff. They created a "savings account" based on figures from a composite annual statement for 1977. The savings account included 90% of life insurance reserves plus 78.6% of all dividends left on deposit by policyholders. The 90% of life insurance reserves figure came from an offhand observation I'd made ten years earlier when someone from the press asked what cash values were relative to reserves. I said, "Well they are less than the reserves, maybe 10% less." The 78.6% figure was derived more scientifically. They determined that of the dividends paid by companies 78.6% went for their individual life policies and the rest went to group insurance and health insurance policies. They looked at the $24.2 billion of premiums that companies received in 1977 and determined that $7.4 billion was for pure insurance. They got that $7.4 billion figure by taking incurred claims for the year and multiplying it by one and a half. The rest of the $24.2 billion of premiums was determined therefore to be a deposit in the savings account.

There are at least three errors of some substance in that calculation. First, they included as deposits in the savings account not only the premiums for life insurance, but premiums for accidental death coverage, for waiver of premium disability coverage, and any other benefit if one opted to purchase additional insurance etc. Clearly, such benefits have nothing to do with "savings accounts."

The second error was to substitute 150% of incurred claims for the "low cost" term insurance rates (used elsewhere in the FTC report) as a basis for Linton Yield calculations. This approach decreased the amount of premiums allocated to pure insurance by about $4 billion with a corresponding increase in the amount allocated to deposits in savings accounts.

The third error was to include the premiums actually charged for term insurance, even though by the FTC definitions most term policies and riders have no savings account attached to them, but rather are pure insurance. This means that they put in as a deposit the difference between the term premiums actually charged and 150% of incurred claims.

Now the intent of inflating the deposits to this extent is fairly clear. The interest actually credited by companies that year to their individual life line amounted to $12.4 billion dollars. That amount never appears in the FTC calculation. They compared the amount in the savings account at the end of the year to the amount at the beginning of the year and concluded that $1.8 billion of interest was credited. But the remaining $10.6 billion was completely ignored.

John Taylor, a fellow of the Society and an Executive Vice President of Banker's Life, testified in October before the Senate Commerce Committee. He spent a lot of time on the errors in the FTC calculation and if you are interested in the numbers you can find that testimony in the ACLI General Bulletin No. 2830, dated October 24, 1979. Some other aspects of the problems were discussed in Best's Review in January, 1980.

As I said at the beginning, the "average rate of return" calculation got all the headlines but it had nothing to do with either disclosure or cost comparison. The FTC staff member responsible for the calculation admitted as much at a hearing before the NAIC in Detroit last year. In addition, he warned that the approach should not be used for a single company as it may produce bizarre results. The question that should be raised is, "if it is not relevant for a company, then how relevant is it for a policy?"

III. FUTURE REGULATION OF DISCLOSURE AND COST COMPARISON

The current NAIC Model Regulation is in effect in 28 states. Four states have the earlier version which is compatible with the current one so that if you comply with the current one you are in compliance in 32 states. There have been hearings in recent months in a number of other states which include Colorado, Maine, Massachusetts, New Mexico and New York. Florida has enacted legislation adopting the current NAIC Model Regulation as a statute. In no cases have the ideas advanced by the FTC staff about rate-of-return cost indexes been adopted.

The NAIC has reactivated a committee chaired by Commissioner Hudson of Indiana. It will be meeting in Denver this month and will probably propose some changes in the NAIC model. As I understand the schedule, the committee plans to air for discussion any proposed changes and hopes to take action in December.

One of the ideas likely to come up is a question of the timing of giving information to the prospective policyholder. The current regulation requires delivery before taking an application unless the contract has the

10-day free look provision. In that case you can deliver the information with the contract. I think it is almost certain that the NAIC will propose an amendment that would require some form of preliminary disclosure whether or not you have a 10-day free look provision. I think it will also look at the contents of the Buyer's Guide and the Policy Summary currently required by the NAIC Model. Every state that has looked at them has felt that it would be a very simple matter to improve them. However, no recurrent theme has emerged at recent hearings.

In summary, the future activity in this particular area will be concentrated almost exclusively at the state level and will probably occur over the next couple of years. My guess is that the NAIC Model will have one more edition and will probably be adopted some time in 1981.

MR. LOUIS GARFIN: Tom Eason has given me a very heavy charge. Not only am I supposed to speak as a statesman but possibly as the conscience of the actuary. I have to confess that I did say, "this is the time for statesmanship," but I didn't realize I was volunteering for the job. I'm afraid that my comments will fall short of statesmanship but you can be sure that I make them in good conscience.

I will speak first on what is bad about the report and then more briefly on what's good about it. It seems that the basic problem lies in the faulty premise that the primary competitive factor to be considered is the "rate of return" on the "savings element" of cash value life insurance, as compared with the rate of return on alternative savings vehicles. This rate of return is then taken also as the only true comparison among life insurance policies. For example, the report says, on page 77, "The rates of return (which are an accurate measure of costs) show an immense variability...." A little earlier on page 70 it says, "The following analysis of the correlation between premiums and real cost demonstrates the dubious reliability of premiums as a predictor of real cost." The analysis, of course, uses the average annual rate of return as a measure of "real cost." Again on page 92 it says, "Although the rate of return is not the only thing a person should consider in choosing between term and whole life, it is certainly an important factor." This quote is particularly revealing, because the rate of return has nothing to do with term insurance but rather with the unmentioned alternative savings.

Not only is this rate of return fixation felt in the evaluation of cost indexes, it is also the theme of the first and one of the worst findings of the report: "The average rate of return paid by the industry to all ordinary life insurance policyholders in 1977 was between one and two percent."

This finding has obviously been criticized and probably with this criticism in mind the FTC staff said, "While the 1977 industry wide rate of return is not of direct help to an individual consumer wondering about the economic consequences of buying a particular policy, in our view it demonstrates the need for effective cost disclosure." This is a non sequitur or possibly worse. In order to "demonstrate the need for effective cost disclosure," it produces information which (as Mr. Minck has pointed out) is contrived and essentially meaningless, whether or not it is true. Also as Dick has said, the methods used to calculate the aggregate rate have little relation to the Linton Yield method which is proposed in the report as the recommended basis for cost disclosure. The report acknowledges this in a footnote on page 25 which says, "The rate of return on individual policies is conceptually distinct from the industry wide rate of return discussed in Part I." As the report shows, there are large differences in results among companies, so the treatment of ordinary life insurance as a monolithic industry subject to a single average rate of return can really have no relationship to cost for any policy, to cost disclosure, or to cost comparison. The publicity given to this finding was in the nature of an indictment of the whole industry on grounds that were far from solid.

The report also makes the considerable argument about the impact of inflation on life insurance, particularly non-participating life insurance. This illustrates again the narrow focus of the report. The discussion of the evils of inflation is equally pertinent - and distressing - for any fixed dollar financial contract. It is even more so if the contract is paid for by a single sum as in the case of a government bond, instead of installments over a period of time, as in the case of an annual premium life insurance contract. In this same context, the report contains the highly publicized statement that, "A great many policyholders (of old non-par policies) would be well advised to surrender their old policies and purchase new participating or term policies." In spite of honorable intentions and disclaimers of "recommending the wholesale replacement of cash value insurance policies," this kind of statement from a government source has surely resulted in ill-advised termination or replacement of policies.

Another thing that bothers me about the whole issue is the lingering conviction that people do not really want to know that much about the comparative cost of their life insurance. The report summarizes two consumer research studies by Professor Jacoby that reinforce that conviction even though the FTC staff reaches a different conclusion. This is another quotation:

> "Although the low cost policy had the highest annual premiums, it also was the only policy offered by a mutual company, the only participating policy, the issuing company had the highest financial rating and the policy had the highest 20-year cash value. Cash value, financial rating, mutual or stock company, and dividend payment were each assessed by more than half of all the participants (in the study). Furthermore, as noted above, the participant stated that premium, financial rating, and cash value were the three most important dimensions explaining their purchase decisions. Therefore, the fact that 82% of those assessing cost indexes chose the lowest cost policy may in large part be explained by those other policy differences. Therefore, the high selection rates of the lowest cost policy do not support any inference that consumers do not need cost information."

Nobody had mentioned it, but there is a close analogy here with the Truth in Lending Laws. I'd like to give you a short quiz about that.

1. How many of you have borrowed money or have a credit card or charge account? I see that all of you raised a hand.

2. How many know what the APR is? That's a smaller proportion, but still pretty good. For those of you that didn't raise a hand, I understand that means the Annual Percentage Rate.

3. How many know how the APR is calculated? That's pretty good.

4. How many have been influenced by the APR in choosing their credit sources? In answering, remember the question is about the APR rather than the other rates that might be quoted. Three!

How many of you are actuaries -- well, I think you get my point. People simply do not use or pay too much attention to the things that are provided for their information in this kind of issue. My contention is that the public would be better served if the index and disclosure requirements were simplified as much and as soon as possible. A requirement could be included that additional information, perhaps of specified items, would have to be provided if the applicant should ask for it.

Are there any good things about the report? I think there are some. Mainly, it got the attention of the industry as well as a lot of other people and it has produced a remarkably unified response, one of indignation and a public attack on the inaccuracies and flaws in the report. Also, I think it satisfied a lot of life insurance people that they should be giving active support to the interest adjusted indexes and the NAIC disclosure regulation. This is something that should have been done years ago. Actuaries alone couldn't have changed the course of history, but with their support the industry might have taken affirmative steps toward more adequate disclosure rather than staying on the defensive over all these years.

The report has also focused attention on some things that need continuing attention. One is the meaning or validity of sales approaches that emphasize the savings features of life insurance. Another is the matter of equity between old and new policies.

The report will also have an influence on product design. We are hearing more and more about products which are explicit combinations of accumulation funds and term insurance. Some new non-par policies guarantee only maximum premiums with actual premiums varying based on investment experience. The report mentions specifically one year term insurance renewable to age 100 which I believe is a product of fairly recent origin.

What should we learn from the report? There are some things it seems to me which insurance companies and actuaries should be learning from this disclosure scenario and others like it. Just a few weeks ago I saw a report on an industry organization which made a distinction between "position taking" and "research." It said, "In positian taking, the emphasis is on what is best for insurance companies. In policy research, the emphasis is on what is best for what we might call 'the public as a whole'." Unfortunately, the first sentence describes the basis on which all too many positions have been taken by companies and by industry associations - their own perceived best interest. Increasingly, the evidence shows that this simply doesn't work very well in the long run.

The jockeying among companies in the history of the disclosure issue was typical of what happens over and over again. The "surrender" index and the longer durations were considered to be more favorable to mutual companies; the "payment" index and the shorter durations, to stock companies, so we ended up with both indexes at both 20-year and 10-year durations. Dividend scales are not guaranteed, so to deal with the stock and mutual competitive interests, the "equivalent level annual dividend" was invented. All are now required by the NAIC Model Regulation.

The insurance buying public was not demanding any elaborate disclosures and even Senator Hart's earlier requests were fairly modest. I believe that if the insurance companies, spurred on by their actuaries, had risen just a little above their competitive interests to support actively a fairly simple interest adjusted index early in the game, much of the subsequent pressure would have been largely defused. If the companies had in fact started to use a common index (other than the old cost index) widely enough to permit comparisons when required in competitive situations, they would have been in a much stronger position to demonstrate that meaningful price indexes were in use for cost comparisons.

Dick Minck has mentioned the current issue of the timing of the first disclosure to the prospect. It is in this kind of issue that what I call "statesmanship" is needed to provide a meaningful solution. Insurance companies might have to forego some competitive advantage or accept some disadvantage, agents would have to assume certain burdens, insurance department regulators might have to compromise on some of their favorite approaches in the interest of getting more enthusiastic general support, and hopefully the critics would give a bonafide effort a chance to work.

Actuaries might take this message from the history of cost disclosure: "When the handwriting is on the wall, read it." We cannot anticipate all of the issues that will arise, but when public concerns are expressed, we should take them seriously and seek solutions. Answers should be based on the public good and not just on what is best for the insurance companies. Self-serving solutions are too often short-lived and frequently backfire. Actuaries, I believe, are supposed to be the good guys. If that means being the conscience of your company, that's what I recommend.

MR. WALTER N. MILLER: Most of my remarks will be geared to some specific questions concerning the report and its effects which our moderator, Tom Eason, asked me to consider.

What is the long term effect of the FTC report on public comprehension and private delivery of insurance products?

As far as overall public comprehension of insurance products and the industry is concerned, the long term effect of this report will be bad. Critically bad? No - I'm not trying to suggest that the report will cause severe problems in this area in the future. But whether we like it or not, the FTC has a generally good public image. The majority of the American public seems to view the FTC as one of the few governmental organizations that really is motivated to act in the best interest of the ordinary person, the little guy. The majority of people view the FTC favorably as being supportive of "good" public goals and benefits for consumers and others. With this sort of situation, the anti-industry stance of the FTC cannot help but hurt us and cannot help but set back good public understanding of our product, and the way it is sold.

Concerning private delivery, I'd like to break my answer down into two parts, one relating to delivery of insurance through the traditional agency system and the other relating to delivery via other methods.

I think the long term impact on sales of insurance through the agency system will be beneficial. This may seem strange after my prior remarks, but our experience has been that - with some help on technical matters from their home office - competent, well trained career agents have been able to handle the problems raised by the inaccuracies and biasses in the report without too many problems. Now, it's true that not all career agents are as competent and as well trained as we'd like, and it's also true, therefore, that the weaker segments of our traditional agency forces have had some problems handling the fallout from the report; but the net effect of all this will be that with the activities of the better trained, more competent, and stronger agents relatively unaffected and the activities of the others hampered, there will actually be a net gain. Perverse though it may seem, the effect of the report may actually be to strengthen the necessary process of further upgrading the knowledge and quality of traditional career life insurance agents - as well as the markets they serve. This can't help but be beneficial in the long run.

With respect to sales activities under non-traditional methods, here I expect that there will be some adverse effect, at least to the extent that the markets served by these methods are presently concentrated in the lower and middle economic brackets. In particular, the lower income people (who are generally targeted by mass marketing and other methods typical in the non-traditional area) will probably put more credence in the report and some of its false conclusions than other groups of people. To the extent this is true, it will hurt.

Is there a cumulative effect on the series of governmental investigations dealing with insurance?

I think there is, but not so much with the public as with the state regulatory system. Right now, the NAIC (as well as a number of state insurance departments) is re-examining the current legal and regulatory framework with respect to cost comparison, disclosure, and related items. Much of this activity is to be expected and is reasonable in terms of an on-going review of public regulatory needs in these areas. But I have no doubt that the intensity and outcome of these activities will be at least somewhat more stringent than it might have been if there had not been the series of investigations referred to, culminating with the FTC staff report.

Has the industry responded adequately to the FTC staff report?

No and yes. In an absolute sense, I'm sure that the industry rebuttals have not reached as wide an audience as the original report, and have not gotten the hearing they deserve. But in a real world context I would answer "yes" because the industry, in my opinion, did as well as it could in a very difficult situation where the dice were loaded against us. You just cannot escape the fact that the nature of this sort of situation is that the party that gets in the first punch is going to have a big edge. And this was accentuated by the fact that, as Dick Minck previously explained, the FTC staff took specific steps in order to assure maximum exposure for their side of the story and minimum meaningful response opportunity for the industry.

One thing this means, of course, is that we must not always be put in the position of responding to our critics. We have a good story to tell and all of us must find better, more effective ways to keep on telling it.

Another thing it means is that there will probably be an increasing number of situations where we have to walk a tightrope, as it were. One example of this is in the area of rate of return (ROR). The FTC staff and some others have pushed for mandatory ROR disclosure. Most segments of the industry and most actuaries that I know have vigorously opposed such mandated ROR disclosure and correctly so, in my opinion. This is because there is strong evidence that rankings of policies using ROR are not at all significantly different from those using the interest-adjusted method and therefore ROR can add no new information as to relative cost. Also, ROR can give perverse results in that if any sort of realistic term rates (i.e., those which increase as the face amount decreases) are used, the indicated rate of return also increases as the face amount of the permanent policy decreases. This is absurd. Finally, mandated ROR disclosure under the aegis of state or federal regulatory agencies would foster the public impression that a "buy term and invest the difference" scheme can produce results exactly equivalent to those under a permanent policy. When matters like availability of non-forfeiture options, settlement option guarantees on the entire proceeds, and tax consequences to the policyowner and the beneficiary are considered, this equivalence just doesn't exist. To do anything that suggests it does is dangerous and misleading the public.

But (and here's where the tightrope walking comes in) opposing mandatory ROR disclosure does not mean that the use of ROR figures should never be considered. In the real world, it is a fact that ROR figures, properly qualified and explained, can legitimately be used as part of a conscientious defense of permanent insurance vs. some rather strange claims made by people and organizations who claim that buy term and invest the difference schemes are the only way to go, any time, in any situation.

Who are our friends? Who are our enemies?

Those involved in state regulation of insurance are our friends. Or, if they are not, they should be - not from the standpoint of being under our thumb but from the standpoint of sharing common goals vs. some of the issues raised by the FTC staff report. Here is one area where we should pay special heed to Lou Garfin's good advice. Even if there is some pain associated with the process, there are accords we need to reach with each other so that we can deal better and achieve better results with our friends.

Among our enemies are some (not all) consumerists, some (not all) academic people, and some (not all) in government. But make no mistake, most of those who qualify under my "some" are dedicated, intransigent enemies indeed. They are out to get us. They don't respect the industry or anyone in it. They don't recognize actuaries as anything but lackeys of the companies who employ them. There is no devious route they will not take in order to reach their foregone conclusions. There are no views which will impress them if they turn out not to agree with their preconceived notions.

A good example of this latter point is that it is an article of faith with many consumerists that leveling commissions paid to agents will produce a vast reduction in the cost of the insurance we sell. Any actuary who has examined this area knows, and can prove, that as long as lapse rates are in the neighborhood of 15% or less for the first year and grade off thereafter, this thesis just isn't true. But no amount of demonstration can convince some of those who push it.

You would expect our own companies, and our managements, to be our friends and this is largely true but not always. In the past, I believe that a few company managements have condoned or even instituted actions and practices which really aren't proper if the insurance industry, individually and collectively, is to make a rational response to consumerists and similar forces. In this respect, maybe the fallout from the FTC staff report is helpful in that in some of these situations, managements will see a threat to their continued well-being if practices such as I have referred to are continued.

But our main enemies are ourselves, the actuaries. When non-technical people attempt to grapple with difficult technical issues, we can't say, "only we, the actuaries, understand these issues and don't you guys mess around with them." To some of us that may seem reasonable, but to most of the real world outside our offices it comes accross as pure arrogance, and it does not in any way inhibit some vacuums being filled by people or organizations who have become active only because as professional actuaries we have not.

We can't continue to cop out as a profession, although it is admittedly very difficult for the Society or any other professional organization to take positions in areas which are fraught with public controversy. Where were we when the really important basic issues of cost comparison and disclosure started to be thrashed out? Where are we with respect to continuation, if not intensification, of some rather impure and romantic sales practices which many of us notice and too few of us attempt to correct? Where are we with respect to fostering sound and defensible standards for calculating dividends? Maybe we're getting somewhere here. At least we will be if the forthcoming recommendations of the Society and Academy committees working in this important area receive the attention and - most important - the support they deserve. But if we don't support efforts like these, we will continue to leave vacuums which will be filled in ways that are not to our liking.

In this cataloguing of friends and enemies, I've so far left out the most important group of all - the public. Where are they? I'm not sure. They're certainly not overwhelmingly our enemies but they're certainly not overwhelmingly our friends either. We're still in a sitatuion where we can influence our own fate and that of the companies and the industry with which many of us are associated. Let's do that.

MR. EASON: Panel, that was magnificent. I think this group should give you all a good solid round of applause.

We are not done yet - would anyone like to discuss any of the topics presented or perhaps put a question to our panel? Please come to the microphone.

MR. JERRY N. LOTERMAN: I have noticed that there has been a lot of reluctance on federal regulation. In Canada, insurance is regulated federally and it seems to have worked very well. I'd like to know why there is so much reluctance to have federal regulation in the U.S., as opposed to state supervision which seems to cause a lot of problems.

MR. MINCK: You've got a very happy situation in Canada where you do have a division of regulation between the federal and dominion governments. In that atmosphere, in a country of your size and with the number of companies involved, it works very nicely. I think in the U.S. we have always been in a situation where we have had a very active set of state regulators who have regulated all aspects of the business. It was for that reason that the Supreme Court held that insurance was not "interstate commerce" and therefore not subject to federal regulation. The way the laws are set up you would be faced with a situation where you'd probably have dual regulation, so it is not the option of federal or state, you'd have both. Where we have had the experience of both they've been expensive and conflicting. I think that it is that as much as anything that has lead to the difference in our two countries.

MR. EASON: I'd like to tell you of one new development and see if you have a reaction to it. There are various studies proceeding on various aspects of the cost disclosure area. The academically oriented American Risk & Insurance Association has scheduled a program in Chicago two months hence. Robert Cooper who is dean of the Hubner School of the American College is preparing a paper entitled "The NAIC and FTC Policy Summary Deadlock — A Possible Compromise." This paper investigates the statistical correlation between rate of return and interest adjusted cost indexes. Mr. Cooper has found an exceptionally high correlation and I understand that his paper will be considered for publication in the CLU Journal within the year. I would ask this group if you're aware of any other research, published or private, which you would like to share with us on that subject or some other subject that might help lead us in future developments. While your thinking on that one, I want to take a poll. How many of you in the room have been asked to calculate or have spontaneously calculated Linton Yield rates on some of your present life products? Can I see a show of hands? That appears to be 60 to 70% of the audience. Would you view expanded use of this measure, whether voluntary or forced, as a good or an evil. Now there are two questions I'm asking you. Would someone stand up and comment on either of those?

MR. JULIUS VOGEL: I would view it as an evil for a couple of the reasons that have been given before. I think that the use of the Linton Yield was intended by the FTC to get the customers to say, "Why should I put my money into a 6% investment when certificates of deposits are earning 10% or 12%." As far as comparing different policies are concerned, the Linton Yield is no more or no less than the "interest adjusted net cost" turned around. Instead of putting in an interest rate and solving for the term insurance cost, you put in a term insurance cost and you solve for the interest rate. I don't see how one index can give you any more information than the other. There are, however, a substantial number of people (let's say 25%) who keep their policies until death. It seems to me that's where the interest adjusted net payment does have significance and of course that kind of information is just not available in the Linton Yield.

If I may keep the microphone for one minute longer, on the matter of buying term and investing the difference, we did a calculation at Prudential for a typical age. We found that if a person had started 30 years ago buying whatever term insurance policy we had at the time, say a five year term, and if we had been willing to make decremental changes in the term insurance policies from year to year at no charge, and if the individual had put the difference in a savings account, then after taking taxes into consideration, what would have accumulated in the individual's savings account would be slightly less than the cash value on a Prudential whole life policy purchased 30 years ago. After 20 years the results were a little more equivocal.

MR. MILLER: One of the criticisms that has been levied against the interest adjusted method is that it is a so called snap-shot type of method. In other words, think of the 20 year interest adjusted net cost, that brings into account only the 20th year cash value and none of the intermediate cash values. Remember though, that a Linton Yield calculation has the same characteristic, it brings in only the cash value at the end of the period over which the yield was measured. So if you don't like the interest adjusted method because of the fact that it doesn't take account of all the intermediate values, you don't solve your problem by moving to Linton Yield either.

MR. EASON: I have one other area I'd like to pique your interest in briefly. There is another paper that will be coming out, I understand, this one authored by a former Society president, Mr. C. L. Trowbridge. This paper addresses the impact of adding a mortality adjustment to the current NAIC method. It explores the use of this double adjusted method in evaluating the worth to a consumer of a proposed replacement. If you are in a practical operating position as I am, you are concerned about that type of calculation these days and I wonder what the state of the art is now within companies on methods for analyzing proposed replacements which might come to your attention. If someone would like to address that I would be very happy to have you do so. Lou, I wonder if you have gotten into that subject in your company's situation?

MR. GARFIN: I have to answer no to the specific question about the technique for countering proposed replacement situations. There is an increased level of replacement activity recently but we don't have a solution for it.

MR. EASON: One thing you might like to do is to try a little different calculation based on a rate of return analysis. What is the rate of return if you take a policy that is five years old and calculate the situation from now on? I think the numbers there (since you will obviously have amortized some of the initial expenses) could be quite dramatically different and rather interesting, at least for internal consumption. Has any one done that in his shop?

MR. JON C. CHRISTOPHERSON: To help our field in replacement situations, we have added an annual rate of return calculation on all ledger illustrations for inforce business. The results, I feel, have been reasonable for policies that have been in force long enough to have cash values. The rate of return on these illustrations is significantly higher than the average yield for the first 20 years.

MR. EASON: Jon have you explored any other methods along the way that appealed to you or is that the only one that you've done much work on so far?

MR. CHRISTOPHERSON: Yes, that is the only one we have done any amount of work on. I have found it rather difficult to find a method that will produce valid comparisons of dissimilar plans, especially when term is replacing whole life.

MR. EASON: As a personal observation on the Trowbridge paper I mentioned, it does attempt and it is rather convincing in pointing out that, with a mortality adjustment you can do some comparisons of dissimilar contracts.

Dick, a question for you. Did anything happen in the replacement model regulation discussions to indicate that there was need to compare costs where replacements were involved?

MR. MINCK: It was clear that the regulators felt that cost comparisons were needed in replacement situations. Moreover, they concluded that there was a great advantage to using the same comparison systems used with new sales to the extent that it was possible to do so. The use of the methods already in place for new sales would obviate the need for additional training of agents. The cost comparison situation is complex enough without having different systems of comparison in different sales situations.

MR. EASON: In any event, that model regulation does not require numbers of that sort, just disclosure of the raw data?

MR. MINCK: That model regulation would develop a comparison statement showing premiums, dividends and cash values for 10 years and at age 65 for both the existing and the replacing contracts. Any companies trying to conserve existing policies would have to furnish policy summaries for their existing policies on the same basis that is required for new policies by the model life insurance solicitation regulation. The expenses of developing cost indexes beginning at odd durations may discourage some companies from making such efforts. For example, many companies might not have illustrated dividends for the next twenty years for a policy that was issued in 1963 to an individual then aged 25. Similarly, they might have no computer system for developing cost indexes in such circumstances.

MR. EASON: Let's be clear on this. Was this a proposal that was discussed or was it actually a part of the new Model Replacement Regulation?

MR. MINCK: It is part of the new Model Replacement Regulation. However, that version of the model regulation has been adopted by about a dozen states and most of the rest have a 1970 version with different requirements.

MR. EASON: I take it the audience is as satisfied as I am with the presentation today. Let us continue and not fool the citizens.