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**TREATMENT OF EXISTING LIFE INSURANCE POLICYHOLDERS  
IN TIMES OF RAPIDLY CHANGING ECONOMIC CONDITIONS**

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WALTER S. RUGLAND, MICHAEL B. HUTCHISON*

1. Impact of Economic Conditions
  - a. Replacement
  - b. Policy Loans
  - c. Other
2. New products to provide greater flexibility for adjusting costs to policyholders.
3. Programs to reflect revised future outlook for actuarial assumptions by adjusting premiums or benefits of existing policies.
  - a. Participating
  - b. Nonparticipating
  - c. Impact
    - i. Persistency
    - ii. Profitability
    - iii. Cash Flow
    - iv. Expenses

The paper "Updating Existing Life Insurance Policies," by Thomas E. Dyer, James J. Murphy, and James F. Reiskytl, will be discussed in this session.

MR. DALE R. GUSTAFSON: The first part of our program today will be a discussion of the paper describing the Northwestern Mutual Program of "Updating Existing Life Insurance Policies" written by Thomas E. Dyer, James J. Murphy and James F. Reiskytl. Then Mr. Sidney LeBlanc of the Pan-American Life Insurance Company will describe the Pan-American Program plus whatever other remarks he wishes to include in his presentation. A key difference between the Northwestern's approach and the Pan-American's approach is that the Northwestern made an offer to the policyholder which the policyholder had to accept or reject, thus a bilateral approach. The Pan-American's approach was unilateral, i.e. they did not have to ask the policyholder to accept or reject the offer. Following Mr. LeBlanc we will hear from Walter Rugland of Milliman & Robertson, Inc. He will talk about this area from the point of view of the small company and the consultant. We will then hear from Mike Hutchison, Chief Marketing Officer of a large Canadian company, Crown Life. He will cover the Canadian scene in this frame of reference, discussing the non-guaranteed premium, a new non par idea, and the update idea from a marketing perspective.

MR. JAMES F. REISKYTL: We are pleased that the Society has approved our paper and welcome the opportunity to describe it to you today. Project Update at the Northwestern Mutual was precipitated by inflation and the resulting high interest rates and federal income taxes. As a mutual company we were able to cope with high interest rates, at least to

a certain extent, and keep our benefits up-to-date through increased dividends. But taxes were increasing more rapidly and the dividend mechanism could not correct for varying tax allocations by reserve block. To resolve that, as a Phase I Company, we had to raise the reserve interest rate on the older blocks of business. We knew what should be done, figuring out how to do it was the tough part. We worked on this for ten years before we finally found the "right" solution for us. Our Update program, which now seems so simple, is described in some detail in our paper. Now that we are halfway through our program we know that we could present it in a comprehensive way and we are very pleased that it worked out that way. The paper also looks at various other methods that might be used. It gives some numerical results using various assumptions as to face amount, premium, premium paying period, etc. A number of practical administrative and actuarial considerations are also discussed.

Update programs stem from a strong desire to provide improved value to the customer. We, as a mutual company, recognize the policyowners as our owners and we strive to do our best to provide them with the finest value. We feel the Update Program does that. However, we also realize that another company in other circumstances may come to other conclusions. To date our program has been very successful with over 2/3 of the people receiving the offer accepting it. That's quite good considering that 20% of our people don't read their mail and we apparently can't crack that barrier. I would like to conclude with the final statement of the paper because it is the way I think the three of us feel. "With the increasing pace of change, there may be a continuing need to find a way - beyond dividends - to keep existing policyowner values up-to-date. The concepts developed in the paper may need to be applied repeatedly in the future to preserve the value for existing coverage." We believe that maintaining real value for our existing customers is a very important part of our business.

MR. SID LeBLANC: My comments today are going to relate only to the update program as opposed to the entire topic of "Treatment of Existing Policyowners . . ." I have submitted a written discussion on the paper. I'm going to read that discussion first and then I'll make some additional comments specifically about the Pan-American program. Here is the discussion: I would like to congratulate Messrs. Dyer, Murphy and Reiskytl on their fine paper and their program to update existing policyowners. This is the type of achievement we like to expect from a quality company like Northwestern.

At Pan-American Life we instituted an "update" program on June 30, 1980 somewhat similar to Method 4 in the paper, and I felt that our experience may be a useful addition to this literature.

The paper describes the major impact on the Phase I tax base. If this endorsement is considered a reissue and there is consequently no ten year spread of the reserve change, the Phase I tax savings accrue in the year of the change. If this is not a reissue and therefore considered a reserve weakening, there is a ten year spread of the reserve change and the Phase I effect begins in the subsequent year.

Although we are Phase I taxpayers, I would like to comment about the effect on taxable gain. One effect is the ten year spread of reserve weakening if this is the tax answer obtained. If the block of business being updated is large enough, there would normally result a phase shift and additional tax savings in the year of the update for Phase I companies.

The additional effects on taxable gain include the additional payments for death benefits and cash values and the increases in reserves in anticipation of these increased benefits. Any dividend change would affect Phase II positive companies. The year by year effect of all of these items on any given company is rather difficult to generalize.

Since the tax savings are an important consideration in the project, I should comment on the future of these savings. I expect there will be changes in the 1959 Tax Act in the near future. The IRS will likely attack modified coinsurance through legislation. The ACLI will likely propose changes to the tax law during 1981. It is unclear what the outcome will be. These changes may make update programs less desirable in the future compared with other alternatives.

Pan-American's endorsement was similar to Method 4 in that the released cash value as a result of the increased interest rate was used to purchase additional insurance. This additional insurance was provided at no increase in premium. The specific formula is that the increased amount of insurance which we defined as (K) equals the cash value for the policy at 2 1/2% minus the cash value for the policy at 3 1/2%, divided by the cash value on the increase.

The major difference between our program and Northwestern Mutual's was ours was on an implied consent basis. There was no additional paper work required of the insured to receive this benefit increase. He received the benefit automatically and did not have to take positive action to accept the change as in Northwestern Mutual's case. This procedure was followed since our endorsement did not affect the policyowner adversely in any area. The paper suggests that reducing cash values by increasing the interest rate would not be possible without insured approval. However, since the effect of our change was that the cash value is always the same or greater, the insured was never adversely affected and insured approval is unnecessary. We assured that the cash values would always be the same or greater by calculating K in the above example at all future durations and giving the insured the largest K generated. Since our block of policyowners excluded recent issues, assuring future cash values were at least as large had little effect. We have also continued the same dividend scale. Although there was some discussion with a couple of states about this point, there were no states which ultimately required that we receive a positive approval from the insureds. However, if any policyholder rejects the endorsement, we would honor that request.

The paper points out some of the advantages of a unilateral approach. These advantages are achieved by our approach as well. In addition, I would include: insuring virtually 100% approval, avoiding the necessity of extensive market testing and avoiding the problems referred to in the paper's section on nonforfeiture values and valuation standards since our endorsement was a policy change rather than a reissue.

Since this is not considered a reissue, there are some possible adverse effects as regards restrictions of options. For instance, it would seem from reading the valuation and nonforfeiture law that it would be allowable without reissue to go to 4% interest; use premium paying as well as paid up reserves as Northwestern Mutual did; and possibly use different net premiums as indicated in alternatives 1, 6 and 7. However, the valuation and

nonforfeiture laws are not clear on these matters and in a filing in 50 states it is likely that some states would raise these issues. A more conservative approach without insured approval is to use 3 1/2% interest, paid up reserves on the increase and 3 1/2% net premiums.

With the severe lapse and replacement problem the industry faces, we hope this move will mitigate those problems. We expect this motivation to lead other companies to similar programs.

This concludes my submitted discussion. To begin further comments, I would like to give a little background on Pan-American Life. We are a medium size company. Including our affiliated companies, we have total assets of approximately \$750 million and total revenues approaching \$300 million. However, excluding our affiliates, our other foreign business, our group business and our health business, we are left with the U. S. individual participating block of only \$350 million assets and \$50 million premiums. Our benefit increase involved only the portion of this business issued before 1964. This block included approximately \$100 million reserves and 35,000 policies. Northwestern Mutual had spent \$6 million to implement their change on 1 1/2 million policies or about \$4 a policy. The defining and refining of such a project as well as the state filings and the computer systems are equally as complex for our smaller block as they are for Northwestern Mutual's 1 1/2 million policies, so there was considerable challenge in our case to hold cost down. Achieving theoretical accuracies at every turn would have made the cost of implementation prohibitive so some emphasis was placed on pragmatism. The total expenses for our project were a little under \$200,000. This still amounts to \$5 to \$6 per policy but given economies of scale, we feel we did an excellent job.

One major reason for our low cost was that we did not require insured's approval. On a block of business this size, it is questionable if it is worth the effort to do this project if insured's approval is required.

Some additional points which may be of interest:

1. Our project took two years from concept to completion and the data processing efforts were completed in a little under a year.
2. We made the increase effective June 30, 1980 for all policies, regardless of anniversary date.
3. The average increase was a little above 10% which was a result of going from 2 1/2% to 3 1/2% valuation basis.
4. All other benefits were unaffected.
5. We excluded term and pension business.
6. We did this through an endorsement to existing policies.
7. Our package to the insureds contained: an explanation letter; a comparison of benefits before and after the endorsement; the endorsement itself; and a question and answer brochure.
8. We installed a toll-free telephone number for insureds' questions
9. The agents' involvement was on a voluntary basis. While there were no commissions paid to agents on this change, there were potentially good leads.

In case you are wondering why we have omitted our foreign participating business, I would give two reasons:

1. The tax savings which result from such a change would be directly offset by reductions in the limitations on foreign tax credits.

2. If you think it's hard to get approval in certain states, you should try to get it on a timely basis in some foreign countries.

Our endorsement was approved everywhere except Virginia which represents about 1% of our business. I understand Virginia gave Northwestern some problems as well, although they were ultimately approved.

I should mention, we are not licensed in New York State.

I would challenge each company to ask the question - Are replacements in the best interest of our policyowners? If the answer is "No" then the problem is communication to the policyholder and possibly the legislators. If the answer is "Yes", then the solution is more difficult. Update programs are one possible answer.

MR. GUSTAFSON: Both Mr. Reiskytl and Mr. LeBlanc, in identifying the genesis and origin of this kind of program, talked about federal income tax savings. That is true, but I would like to point out that one of the simple facts of this kind of program is the increased amount of insurance. In effect it is providing more benefits per dollar of premium for these old policyholders, thus in a real sense there is an updating of the insurance. They are getting more insurance per dollar of premium, thereby bringing those policyholders towards the new product. Just for clarity I would like to expand on one of Mr. LeBlanc's remarks. He said "We have also continued the same dividend scale" and that is an important feature of the Pan-American approach. What that amounts to is that there was a corresponding increase in the dividend interest rate. That is if the dividend interest rate was x% and if you pay the policyholder x minus the reserve rate and if you increase the reserve rate from 2 1/2% to 3 1/2% and you do not change the dividend you have in effect increased the dividend interest rate. There is nothing wrong with that, but it is a key point in the Pan-American approach.

MR. WALTER S. RUGLAND: I have some preliminary comments regarding the update question in various client company situations. The first is an understanding and a realization that the U.S. economic environment is very different from what all of us were trained to recognize it to be. The economic conditions which are now being experienced are really different from what went into the model building which constructed the basis on which our existing products, procedures and company structures have been put together. In the long run we really need to redefine individual life insurance, level premium assumptions, valuation principals that we are working with, the context of cash value equity. All of these things are creating much of the discussion and activity that is going on within the life insurance industry and within the minds of businessmen today. The individual life business is at a threshold point. It needs to redetermine its basic mission. This probably won't last very long because we are in a phase that is going to require us to continually adjust until we see the direction in which things are headed. We are going to focus as an industry much more on marketing than we are on the financial aspects of the business. We are going to therefore have to more specifically define markets and design products to fit those markets, but those are generalizations and do not fit with every company. The standardization of life insurance policies flies in the face of that thesis. We really need to build on our strengths and to create more strength company by company to wrestle with these particular problems.

There is one other piece that has to go into this session and that is where the company is most vulnerable. A company is probably most vulnerable in retaining their existing books of business. Take a look at the conditions that exist. One is that life insurance agents, on average, have decreased income. They are looking for places to create money, in the form of commissions, and the obvious place to find those pots of money is in existing cash values that have not yet been borrowed. We are also facing a change in the commitment to life insurance as it has been taught, as it has been trained and perhaps as it is being utilized. Another condition that exists today is that benefits need to be updated, most programs are out of date. The last condition we are facing is that we have been only marginal in our service to existing policyholders. We continue to validate a full time career agent in a market to which he does not aspire to succeed. We are creating all kinds of business which we, by definition, will never service.

Now with that background I would like to discuss the update concept as it specifically relates to non-par and small company situations, although many of these considerations speak directly to small mutual companies also. I have classified my comments under three headings: identifying the motivation, locating the source of funding, and acknowledging the reality. There are two types of motivation which form a big part of management philosophy. One is an offensive motivation, the other is a defensive motivation. The main issue on the offensive side is the realization of tax savings. A second aspect of offensive motivation is company image. Another is the impact it can have on new business by matching our current approach to development of new business with that which we have on our books. Retention of existing business is a primary factor of defensive motivation.

The next category is source of funding: where does the money come from? First, it can come from reduced taxes, which has been covered in previous discussions. Secondly, it can come from reduced or varied nonforfeiture values and dividend payoff values. In other words we are just reshifting the slope of things as they look to occur in the future. And lastly, it can come from reduced company earnings. This would mostly apply to non-par situations but it may apply in mutual discussions also. This is a very, very critical question: where does the money come from?

The next point is facing up to reality. Given that we understand the philosophy of a company's management, i.e., its motivation and where it is willing to bite the bullet with regard to funding, we really need to look at the current considerations that would impact whatever design is developed. I have four areas here. The first concerns marketing considerations, marketing being more than just sales but the total impact it will have as the company moves into a marketing mode of operation as opposed to a financial or investment mode of operation. The second concerns equity considerations, i.e. to what extent we are concerned about maintaining or creating equity among policyholders or between the policyholders and other people whom we serve. The third point under this reality issue addresses earnings considerations. There are very significant questions here in terms of the surplus requirements that various states may ask a company to consider and the impact on a non par company in the United States with regard to GAAP earnings approaches. And the fourth point deals with administrative considerations. This has the smallest impact on design because I really believe if a company wants to do something bad enough it will figure out how to do it. Out of this whole analysis perhaps comes an answer to the question of whether the approach should be unilateral or bilateral. A

unilateral approach requires that everything be better and that you have a good argument to make with the regulators with regard to handling the question of nonforfeiture and valuation interest rate linkage. A bilateral approach requires a rearrangement of things and it becomes pretty important as to how well you can communicate that concept to your policyowners. It might be appropriate to look at four scenarios with regard to all of these philosophical and reality concepts. The first is the Northwestern Mutual's situation. The driving force in this situation is equity among policyholders with a secondary driving force, which follows very closely, being the tax situation. In this instance, taxes really are part of the equity consideration. The second scenario is the Pan-American situation. The driving force there was administrative simplicity and the equity question. The third scenario deals with a non-par Company X. Replacements are increasing, new products are very attractively priced, there was a turnover in the agency organization three years ago and things are really different. GAAP earnings are increasing rapidly but the key agents, who are now much more product and price oriented, are losing loyalty. There is concern about the existing book of business as it is influenced by the key agents and by other people in the market place. Obviously the driving force in this scenario is defensiveness and there is a conflict in image between the past and the current that needs to be addressed. A fourth scenario deals with a different, non-par Company Y. New products are attractive but not better than midrange in the competitive spectrum. There is a heavy swing in that company to more term insurance. Agent compensation is decreasing. Market research says that this company is labeled among the agent force and the brokerage community as a high price company. The GAAP earnings are exceptional and the stock is going up steadily. The driving force for an update program in this company situation is a different type of image than in the previous scenario, which was a defensive image situation preparing for a conflict. These scenarios are not all inclusive. They do point out the very important fact, though, that the updating situation is a problem of very wide scope and needs to be considered with regard to each individual company situation.

The consultant role is the same as a member of a company's actuarial staff. There are perhaps several special situations which consultants bring to some companies that are different than the staff actuary might bring. One is greater objectivity and evaluation of the motives, the considerations and the reality issues. Another is that the consultant will be able to help determine what fits best for a company as opposed to what is working best in the market place. The one word that best describes the consultant's role is that of arbitrator between various points of view. In the long run the consultant serves as a staff actuary identifying management options and helping them follow the preferred course in their marketplace.

In many companies replacement is a function of field control of the existing book of business. It is more a function of the ongoing client contact than it is of price, more than it is a business increase, more than it is of "what have you done for me lately." I am not convinced that a company will void its replacement trend by having a policy update. Another consideration in the replacement area is that the big cash value policies are perhaps already borrowed and the cost of salvaging those policies may not be worth it.

The second comment is with regard to the constraints in the regulation area and I touched on the deficiency question. The real question here is whether the linkage between the nonforfeiture and valuation interest rate as it is in the laws really needs to apply in this situation. There is room for deviation from that law on a state by state or regulator by regulator basis.

The key points again: what is the motivation, where will the money come from, what are the realities of marketing, equity, earnings and administration, and should it be a unilateral or bilateral situation.

MR. DALE GUSTAFSON: Regarding the question of who pays for it, the Northwestern's decision was that the administrative costs and the set up costs were to be a general charge to surplus, rather than being charged to the updated policies. That does not mean that that is the only answer; another company might handle costs differently. In describing the motivating force, Mr. Rugland accurately described the two primary motivating forces for Northwestern Mutual as being equity and tax savings. There was a third motivation that wasn't prominent in our early thinking but it was there. It became very, very important before we were through, and that is the concept of marketing. The best way to characterize this from our point of view is that our chief executive has stated on a number of occasions, and I can't quote him exactly, that 'Nothing that has ever been done by the Northwestern Mutual in its history so clearly cements the image of Northwestern being the policy-owners' company than this update program.' It has had a very powerful impact on our agency force. They are very enthusiastic because of this program, in spite of the fact that there wasn't a dime in it for them. 1980 is a marvelous marketing year for us and this is one of the reasons. It was present at the outset but our realization of how important that would be grew as we went on with the program and has now really been proven in the event.

MR. MICHAEL B. HUTCHISON: Let me talk a little bit about the so-called "New Breed" of Pseudo Non-Par policy, which I will call Lowcost Life. Generically the plan might be described as a "Guaranteed Renewable" Whole Life Plan, borrowing the term from disability traditions. Everything is guaranteed, just like regular non-par whole life, except the premium, which may be increased or decreased in the future. This may be done at the Company's option, to reflect revised future actuarial expectations, usually after a suitable initial "guaranteed" period, and subject to a stipulated maximum premium.

This product has emerged today as a glowing example of the industry's responsiveness to the need for better "treatment of existing life insurance policyholders in times of rapidly changing economic conditions." Certainly our promotional literature trumpets, and hopefully history will record, that this "New Breed" of policy is better suited to the needs of the buyer in the 1980's than are traditional forms.

However, the emergence of the product has been dictated more by competitive pressures than by esoteric considerations. That is not entirely a bad thing in that it indicates the positive impact of healthy competition in our industry despite consumerist claims that no such competition exists.

Let me take you back in history to offer my view of the evolutionary manner in which competition created this product. In the mid 1960's the



buyer had a clear choice between the lower fully guaranteed premiums of non-par or the higher premiums, and possibility lower cost, of par. In the U.S. the separation was even more pronounced than in Canada because of the necessary association of mutual companies with par, and stock companies with non-par. Each type played its own role and there existed very little overlap. At that time a rather creative mutual company actuary applied his fertile mind to the problem of how a mutual company's par product could compete directly with a non-par product. The result was enhanced protection, a Par Whole Life Plan which used the dividends in a new way, combining paid-up additions and one year term insurance additions to produce a level amount of additional insurance, called the enhancement. Thus emerged a product which provided the same level death benefit as Non-Par Whole Life for a guaranteed premium lower than the traditional Non-Par Whole Life premium. For the simple actuarial reason that the death benefit was not fully guaranteed, the normal "provision for adverse deviation" in the Non Par premium could be omitted or reduced. The non-par companies had a competitive problem.

It's interesting to note that the stock companies have taken so long to come up with an antidote for this product. But finally this new product has emerged - a "non-par" policy that competes with the mutual companies' "enhanced" competition with the traditional non par policy.

When we introduced our "enhanced" par product our agents were less than overjoyed. They wanted something less complicated - a simple whole life plan with a variable premium. And since we couldn't think of a legitimate actuarial rebuttal, we had to introduce the product.

Being a pioneer with this product has not been easy. In the first place, no one understood it. Insurance commissioners insisted that we include a maximum premium. Then everybody thought it was a Step Rate plan, whereby after the initial guaranteed period, the premium would jump to the stated maximum. It wasn't until the plan was three years old, and we decreased premiums on the first policies issued that anyone would believe that the policyholder wasn't going to get zapped.

The problems encountered with the introduction of this product were many and varied. We've spent years fighting with insurance commissioners who don't tend to easily approve new policy forms. Also, the application of the standard nonforfeiture laws has been a difficult and undefined actuarial exercise. And finally, deficiency reserve requirements can also get pretty onerous. We're still fighting that last battle.

A great deal of concern has been expressed by commissioners about the potential for misrepresentation - the concern being the historic experience with "guaranteed renewable" disability insurance, where premiums have in fact tended to go up. I suppose that it is likely that an agent will put more emphasis on possible premium decreases than on increases, but the risk of misrepresentation is certainly no greater than with the sales presentation of dividend scales especially with regard to new money products.

Interestingly, the policyholder does have some very subtle protection against rate increases. There are the visible guarantees of course - the initial guaranteed period and the maximum premium - but these are almost meaningless with regard to the initial guaranteed period. Expectations are

unlikely to change very much in the first two or three years, and even if they did, most companies aren't administratively efficient enough to change rates that fast. The maximum premium is usually somewhere in the neighborhood of a high par premium, so the probability of expectations getting worse than that is perhaps remote.

The real protection is invisible and arises from a subtle difference between this product and par insurance. With par insurance, if expectations wane, the actuary can decrease his future dividend scales without anyone really noticing, the natural increase in dividend scales tends to mask minor adjustments. Thus, an actuary can fine tune his dividend scale with little difficulty. With our Lowcost product, the actuary must increase his premium in a fishbowl for all to see, with all of the resulting persistency problems, problems of credibility with policyholders and field morale problems. Thus, the actuary, will be a little more hesitant to take the step than he would be to change his dividend scale.

All told, I must wonder whether the pioneering has been worth the trouble. Only now that all the respectable companies have entered the market have our sales finally taken off.

Some Canadian companies have extended this concept to areas where they are different. One of the very popular ones is to move away from a portfolio interest assumption to a new money interest assumption. We have something in Canada called a "new money" whole life plan which operates essentially the same way as our Lowcost, except that the continuation of the coverage depends on the continuation of a current "new money" interest rate. If the "new money" interest rate falls the death benefit will be reduced accordingly, subject to the policyholders option to pay additional premiums to keep the death benefit up. This produces very attractive numbers and the inability of either agents or policyholders to really differentiate between the new money investment risk and the portfolio investment risk has made this product very popular on the street with strong endorsement from banks, accountants, lawyers and the media. This "new money" concept also has some uses in single premium form, which as you can imagine, can be a very useful replacement tool. But aside from the replacement problem, the real questions are whether the buyer understands the investment risk he is assuming, and whether he really should be exposing his insurance program to that risk.

It's fascinating that eight years ago when we introduced Lowcost Life we had a great deal of difficulty getting anybody to accept the notion that the policyholder should assume a "portfolio risk" essentially similar to the one he'd been assuming in par policies for years. Yet today, both agents and buyers are flocking to the idea that it is perfectly proper for a buyer to take a "new money" investment risk which could decimate his insurance program in the future, at a time when he can least afford it. It may well be that the buyer's time horizons will continue to shorten in the face of high inflation and interest rates, and that he will be happy to accept shorter guarantees and greater long term investment risks. The shift to term insurance plus new money funds seems to indicate a willingness on the part of the buyer. However, the industry does have an obligation to make sure the buyer knows what he's getting into.

Other developments in the aberration of the traditional whole life policy in Canada include the equity linked policies (called Variable Life

in the U.S.) issued a decade ago at the time when the market was peaking. They were easier to introduce in Canada because of less red tape but they were not any more successful in Canada than they were in the U.S., where you couldn't even get them into the market place.

Borrowing from Canada's links to the U.K. a number of companies are introducing whole life policies with non-guaranteed cash values to avoid some of the investment risks we now suffer. Certainly there has been an increased emphasis on paid-up values and a de-emphasis on cash values as far as the primary nonforfeiture value. It is however difficult to overcome the industry's self-induced cash value fetish, more so among actuaries than field personnel. All of this innovation will help to insure more equitable treatment of existing non-par policyholders in the future. Coming at it from the other direction, it will protect companies from the long term risks that are now causing some problems. It's all a matter of who assumes the risk. We seem to be moving into an era when the assumption of at least the investment risk by the policyholder is acceptable and even preferable. The length of this era will depend heavily on the length of the interest rate cycle.

None of the foregoing, however, does much to improve the lot of existing non-par policyholders except those of other companies. Unfortunately, stock companies are less likely than mutuals to find themselves in the situation where updating solves the problem. Many stock companies will not find themselves in the tax situation that helps motivate such noncontractual generosity. Moreover, stock company management is on the horns of a dilemma, trapped between, on the one hand, its obligations to its non-par policyholder and whether these obligations extend beyond the policy provisions, and on the other hand, its obligations to its shareholders to reward them for the risks they have borne with regard to existing non par business. I don't have any easy solution to that problem.

Finally, what does the field organization think of all this? As with most issues, you can find the entire range of opinion represented by various members of the insurance selling community. The Northwestern Mutual program had a tremendous effect on field morale, but undoubtedly there are agents out there who would want an even larger increase in death benefits. Any company with a captive field organization can probably convince and excite them about anything they introduce. The Northwestern Mutual approach is particularly saleable because it locks in the clients and helps with resales.

Replacement artists love all these product innovations as they can have a field day improving the policies of other companies' existing policyholders. This kind of replacement activity creates an interesting secondary effect. The loyal hard-working agent finds his clients attacked with both misrepresentation and also with some mathematical demonstrations that are hard to refute. He finds himself in a dilemma of whether to be loyal to his company by preserving the existing business, or to protect his status with the client by brokering a replacement policy before somebody else does. Aside from the motivation of the commission it is pretty hard to blame them for taking the latter course if the company is going to lose the policyholder anyway. Also, a good many agents feel either confused or resentful or both.

They feel confused because their companies seem to be telling them that the insurance products they sold in good faith in years past are somehow no good today, while on the other hand they penalize them if they attempt to replace these inadequate products. They feel resentful because they see in this trend the same insidious erosion of the agent's earnings they have observed and experienced in the term market. For years agents have watched their earnings per \$1,000 fall as premium rates have fallen. In a world where the price of everything else is going up, and the earnings of the sellers of everything else is going up, they wonder whether they are really being fairly treated by their companies in this wave of "actuarial innovation." It is a question to which all actuaries should pay more attention as we design these exciting new vehicles.

MR. GUSTAFSON: Let me review again for the Society the history of insurance regulation in the United States and the prominence in that history of one Elizur Wright. He went to England in the mid-1850's to study actuarial science and to examine the life insurance business. One of the things that made a very indelible impression on him both in England, and to a limited extent in the United States, was the public auction of life insurance policies, level premium whole life insurance policies without cash values. When the individual owners of those policies reached an advanced age and they no longer had the means to pay the premiums they could sell those policies in the open market for a market cash value. The problem was that the purchaser then had an adverse interest in the continuing longevity of that policyowner. It was those humiliating and actually dangerous transactions that brought Mr. Wright to develop the nonforfeiture aspect of the Massachusetts Insurance Law and historically bring about required cash values. Well, either we've forgotten that history or we believe that man has grown more mature and can now cope with that more effectively. It may help to think a little on those origins when designing a permanent insurance product without cash values.

MR. RUGLAND: I have some comments on the impact of these changing economic conditions as they affect product development activities. We've all seen what's happening in the term insurance area. Companies pursuing this market have abandoned the goal of trying to get some asset base and perhaps have abandoned some of their rationality. In the adjustable life area both par and non-par considerations are underway. You can characterize this development as one which abandons the lock-in on the plan and instead speaks more importantly to needs as they change. The continual updating of an adjustable life policy perhaps hides some of the weaknesses that still would exist with an adjustable life policy as it continues in force. The indeterminate premium or the non-guaranteed premium abandons the guaranteed cost aspect of a permanent life policy, single premium life abandons the investment risk to a great extent, and the protection-plus-accumulation type policy, also known as complete life or total life, abandons the tradition that says there is only one entity.

The other thing that is beginning to appear is product development in terms of changes in the nonforfeiture law and standard valuation law. What we are trying to do in the effort is recognize that these laws are out of date while still trying to make them workable. There are some specific situations which can emerge from these changes. One of them is that we may see a return in some measure to endowments as a viable policy form within the United States.

MR. ALLAN D. GREENBERG: Most of the updates and some of the new products out today are very much dependent on a continuation of the current tax environment. What would happen if this environment were to change severely, particularly with respect to two situations; one, Project Update at Northwestern Mutual and the Pan-American program and second, the tax position with respect to a lowcost life insurance product?

MR. GUSTAFSON: It is true that at Northwestern Mutual we based our analysis, our calculations and our illustrations for the policyholder on the basis of the 1959 Federal Income Tax Act for life insurance companies. We discussed with great anguish the risk of a change in the law and we decided in simple terms that it was a risk worth taking. This is the way the law is today and to try to base management decisions on a hypothetical conjecture about what the future tax law might be would totally paralyze us. Even though we measured that risk as being quite a bit larger than zero we took some comfort from the idea that the weight of the 1959 Federal Income Tax Act on the Northwestern Mutual is very great. We felt there was a fair chance that with any restructuring of the tax law we might come out a little better than we are today. Plus, while the relationship between those who updated and those who didn't might be different than in our illustration, that difference would largely be to the advantage of those who didn't update. We think the chances of the updated policies being actually harmed by some change in the law are exceedingly remote.

MR. LeBLANC: The ACLI, GAO, and IRS will all likely propose changes in the 1959 Tax Act during 1981. Congress will stir this input with comments from non-life company competitors and probably pass some amendments to the tax act. The timing and ultimate form of these changes are completely unpredictable. In this regard, updating is no different from pricing. We can't stop the world while we wait for a new tax law.

MR. THOMAS F. EASON: My question is prompted by Mr. Hutchison's discussion of the chronology of events leading from enhanced protection to non-guaranteed premiums. It is an easy matter to add a dividend option to an existing par policy which parallels the enhanced protection option. Term purchase rates can be met, and they can be low. In my company the policy benefits could theoretically be increased by a flat amount of 30% and more. What actuarial and marketing reactions does the panel have to this idea to benefit existing policyowners?

MR. HUTCHISON: Speaking from a marketing perspective, I think you are right. I'm not aware of any companies who have dramatically pursued that avenue, but perhaps somebody has who has an enhanced policy.

MR. GUSTAFSON: The concept of going back to old policyholders is no longer the forbidden thing that it used to be. At Northwestern we have devoted no resources to this general idea yet but it has surfaced during our discussions. Now that we found out how to do it and that it doesn't hurt too much, maybe there will be other update-type programs that we might decide are important enough to do in these inflationary times. For example, our block of old business is just like everybody else's. It has a very low average size policy that does not count for much today. Maybe there is a way to go back to those old policyholders and update the amount not by 15% percent as we did on the average update but maybe double the amount or triple the amount to restore the economic value of those policies. Obviously

that implies term insurance. You have just indicated the mechanism of the enhancement as a possibility, I think we are going to have to seriously look at things like that as the decade goes on if this least likely of all possible economic worlds continues to hold.

MR. REISKYTL: I have two quick reactions. First, if you make it an option that anyone can elect you should probably be concerned about anti-selection. Second, how are you going to 4%? One of our first update thoughts ten years ago was to simply update our additions by dividend usage because for many of our policyholders, the addition balance is greater than the original face amount. We could, we thought, accomplish perhaps a unilateral, or very simple, program. But at that time we were advised that legally we couldn't have dividend options at a different rate than the base policy. Since then of course State Mutual and some others have introduced 5 1/2% paid-up additions on a 3 or 3 1/2% base policy so perhaps that is not the legal hurdle it was thought to be.

MR. NICHOLAS BAUER: Referring to Mr. Hutchison's comment about the self-induced cash value fetish I wonder if he is really referring to the self-induced guaranteed cash value fetish. Many years ago life companies in the U.K. offered a level premium whole life policy without cash value, as Mr. Gustafson has described for us. The distasteful practice of selling those policies in the open market has not occurred for many, many years, but yet the British companies happily offer non-guaranteed cash value. They do, however, offer a cash value, and that is an essential distinction.

MR. HUTCHISON: If you go back in history you find the assessment society which discovered they were unfair to the young, subsidizing the old. Then you find yearly renewable term which solved that problem but became too expensive and lapsed before people died. Then there was level premium whole life insurance without cash value which solved the problem of people out-living their ability to pay for their insurance, which is what was described. It seems to me the logical nonforfeiture option in that situation is the paid-up value or some form of continuing insurance and that the cash value should have been a relatively incidental present value, either a guaranteed value or a market value. But over the years we have turned that around so that, as actuaries, we all learned about cash values first, and paid-up values and extended term insurance later. Our rate books show only the cash values year-by-year, not the paid-up values. Out of that emphasis on cash value has emerged a bunch of funny games we all play, minimum deposit and split-dollar, the fifth dividend option, and the policy loan problem. All because we have, with the emphasis on the cash value, marketed over the decades the ability to borrow at cheap rates. The issue that life insurance is not a good investment is our own fault. Life insurance should not be an investment but we, with our emphasis on cash values whether they're guaranteed or not, have turned it into one in the minds of our critics. If we could somehow turn it around and make it a long-term security program, we might not have some of the problems we now have because of our cash value fetish.

MR. JOHN C. MAYNARD: Guaranteed cash values emerged at a time when interest rates did not fluctuate over the range that they do today. They were meant as a solution to a problem which existed in that environment. The question which Mr. Bauer raised of 'if you offer a cash value, why a guaranteed cash value?' has not really been answered. And it's a very deep question because the whole thrust of the nonforfeiture legislation means that you have to

run a fair nonforfeiture value. I don't think its been proved that to be fair you have to give a cash value which is guaranteed, in the light of all the fluctuations in interest rates which we are seeing today.

MR. GUSTAFSON: Points well taken. My comments were very narrowly and strictly addressed to the idea of permanent life insurance with no residual value. I might argue with Mr. Hutchison about whether limiting the value to a paid-up insurance would really solve the problem. Certainly the economic circumstances in the U.S. today very strongly favor a non-guaranteed cash value. With the new model valuation and nonforfeiture laws that are going through the states, it is now possible to use a 5 1/2% interest rate for the guaranteed cash value. And thus even within the very narrow constraints of U.S. law a company can move towards a substantially lower guarantee. With the 5 1/2% minimum cash value you can bring the value of the contract back up to where it is competitive, through a non-guaranteed termination dividend. Product design constraints are not quite as rigid in the United States as they have been in the past.

MR. JULIUS VOGEL: I've heard conjecture that one possible result of an individual who has his policy updated by 15% would be to surrender, say, 1/6 of his enhanced contract. He would then get the money, have a smaller premium, and have the same coverage with which he started. Has that actually happened to any noticeable extent?

MR. GUSTAFSON: We have the mechanisms in place for this and we have a rather open and free policy change procedure available. However, we have seen that the policyholder is not apt to think of this himself, that an agent must come out and work on it. And there is nothing in it for the agent. We have seen little of this out of the 800,000 policies to date.

MR. REISKYTL: I would like someone to discuss the effectiveness for a mutual company of developing a non-guaranteed premium approach for an existing block of business.

MR. RUGLAND: Most company managements are opposed to any type of activity which would reduce cash flow income. That was the rational Northwestern Mutual used in developing their program, i.e., the enhancement of benefits is a much more desirable approach than reduction of premium income through premium credits or anything else.

MR. GUSTAFSON: But it is easy to conceive of a bilateral non-guaranteed premium approach for old business that would include an offer to the policyholder to increase his face amount by x% instead of reducing the premium x%.

MR. ROY A. BERG: How do you deal with the fundamental question of equity when the largest percentage increases in amounts of insurance go to the young policyholders and the new policyholders. The smallest percentages of increase go to policyholders who are older and have had their policies for relatively long periods of time. For an ordinary life plan, the percentage increase at update diminishes to zero as the Insured approaches attained age 100. It seems to me that if there is to be any variation by age or policy duration, that the percentages should be tilting in the opposite direction.

MR. GUSTAFSON: I can speak for the Northwestern Mutual in saying that it never occurred to us, as actuaries, to question the equity of the pattern of percentage increases which resulted from equating the values on our actual experience mortality table. In fact, looking at it from a different direction, does equity call for a uniform increase? An analysis of the actuarial underpinnings will show this to be a false impression of equity. Thus, we will resoundingly defend what we did as equitable.

MR. LeBLANC: It would seem to make sense to give younger policyholders a greater increase because it costs less, or rather, the amount of their released cash value is equal to the amount of the benefits they purchased.

MR. RICHARD BISSON: Have you met any problems with reinsurance? For example, if you have a Modified Coinsurance treaty would you have to recalculate the interest rate on the reserves?

MR. GUSTAFSON: Yes, we reinsured part of the risk. Potential antiselection could adversely affect future dividend payments and weaken our competitive position. We also increased our case by case retention for large amounts that came about because of Update.