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THE FUTURE OF PERMANENT LIFE INSURANCE

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1. Will cash value life insurance as we know it continue to be viable in light of:

    a. Uncertain economic future?
    b. Double-Digit inflation?
    c. Increasing policy loans?
    d. Extremely competitive term policies?
    e. Replacements?
    f. Attractive alternative savings products?
    g. Consumerist and regulatory atmosphere?
    h. Possible changes in tax, nonforfeiture and valuation laws?

2. If the answer is no, what type of products should be developed to:

    a. Serve the needs of the consumer?
    b. Maintain the economic viability of the company?
    c. Solve the problem of marketing compensation?

3. If the answer is yes, what modifications, if any, should be made to existing products?

4. What are the current effects of replacement on both the life insurance company and the consumer with respect to:

    a. Deposit term?
    b. Single premium whole life?
    c. Other products?

MR. KENNETH T. CLARK: The future of permanent life insurance is a subject which, perhaps more than any other, captivates and at times exasperates the imagination of each actuary in the insurance business. Permanent life insurance is the glory, the jest, and the riddle of our world. It has not now the force which it had in the old days. It is not so robust as we should like it to be. Some say it is sick. If that is so, it is certainly not sick unto dying. For, in spite of the ground it has lost in the marketplace, it continues to be the most important product in the industry.

MR. MYRON H. MARGOLIN: The traditional cash value life insurance product has hardly changed since the horse and buggy days. But neither have eyeglasses, the electric light bulb, nor the zipper. Eyeglasses have not been eliminated by contact lenses, nor incandescent light by fluorescence; and most of us use zippers every day. These continue to be viable products.

Of course the epitome of a product that originated in horse and buggy days is the automobile. Most of the defining characteristics of the automobile have hardly changed or have changed very slowly. It still rides on a road on four tires; it still uses a gasoline engine - usually - with a piston, carburetor, etc.; it has headlights for night driving, and so on.

How is the automobile sold? Rather inefficiently, one might say. Instead of large regional auto supermarkets where all the models are gathered together under one roof, we have all these independent agencies, each pushing its own product line. The auto industry supports a lot of salesmen, 150,000 at last count, and the typical auto salesman sells an average of - you guessed it - one car per week.

I can recite many more parallels and analogies - some of them may be superficial, some of them not. We could talk about the efforts of the federal government to require indexes to enable consumers to make comparisons - EPA ratings, like Linton Yields. We could discuss whether a car ought to be viewed purely as basic transportation, analogous to basic protection. Why are dealers' profit margins highest on the most expensive models, those with plenty of options; and profits least on plain, basic transportation models? What about the high front-end load - consider how much less a car is worth the moment you drive it out of the showroom? We could go on and on.

But I will refrain from dazzling you with all these clever analogies. The point is this: The automobile industry in the United States is another example of an industry dependent largely on one type of product, one which has changed only gradually since the horse and buggy days. Now, because of inflationary pressures, fueled especially by sky-rocketing gasoline prices, it is undergoing some sort of convulsion. People are asking - and I will paraphrase the first question in our program - Will the traditional automobile, as we have known it, continue to be viable in light of various factors?

I am asking this question in terms of automobiles because I think the answer is the same for the automobile as for the traditional life insurance product, and because I think the answer is more obvious when you look at the other fellow's problems, without all the emotional baggage and preoccupation with detail that hinder our looking at our own. In both cases I think the only answer we can come to is: "It depends; and mostly it depends on us, the industry."

First, it depends on whether the industry is going to try to dictate to the consumer and give him what the industry wants, or is it going to find out what the consumer wants and anticipate what he will want and give him that.

Second, I would say that what the customer wants, and will want in the future, depends very much on which customer. There is no pat answer, no panacea or nostrum for everyone. A great deal depends on which market segment you are talking about. Some customers want basic, cheap transportation or protection. Others want more elaborate kinds of models. The product mix - how many want which model - may change. It may change rapidly in rapidly changing economic conditions - but there will always be a mix.

A lot depends also on consumer psychology, which almost by definition is unpredictable. If everything depended just on numbers and economics, everyone would keep a car at least five years, and everyone would fully borrow out his policy. But people do not behave just by numbers. Their preferences for different types of insurance - or even whether they will want insurance at all - depend heavily on their psychological perceptions.

This is not to say that the economy plays no role. On the contrary, what is good for the economy is good not only for General Motors but good also for Prudential. I will say more about the economy later.

Government policy in general, and tax policy in particular, will continue to play an important role. Tax deductibility may induce businessmen and professionals to buy large sedans or sports cars instead of subcompacts and likewise to purchase cash value life insurance for key men or for other purposes. Also, the 4-out-of-7 rule and the tax status of the inside build-up will remain of vital importance in the U.S., and not just for businessmen or the self-employed.

Now, these remarks may seem somewhat equivocal. I offer no definitive opinion as to whether permanent insurance will prevail or will die out. It depends, as I have said, on the economy, on the actions of the industry, and so on. In other words, I disagree with those schools of thought that favor a totally unequivocal answer.

One of these is the term insurance school. The phrase "Buy Term and Invest the Difference" is at least a generation old, and for at least that long we have heard predictions of the imminent death of permanent insurance. A more recent variation on the same theme, or should I say a more recent twist, is the Deposit Term concept. It is the same old story. What is true is that now the pendulum has indeed begun to swing. The ratio of term insurance to permanent sales has risen substantially in the last several years.

But these same years are unprecedented in modern economic history. Not only are they years of double-digit inflation, but they are the first span of years in a very long time when real incomes have generally been declining. If inflation remains at today's levels and if real income continues to decline, maybe the pendulum will continue to swing towards term insurance. Families may view cash value life insurance as a luxury they cannot afford while their real incomes are being squeezed. Indeed, the experience of other countries in inflationary times bears this out. But many of us are hopeful that double-digit inflation and declining real incomes are not here to stay. At this point, all we can say is that the future of permanent insurance and its appeal relative to term insurance hinge very much on the future of the economy.

Another school of thought that predicts the end of the traditional whole life product is the Universal Life school. I am sure everyone here is at least slightly familiar with this type of product. It was originated under the name Total Life by the Life Insurance Company of California. The name of the product has changed, and the company now goes under another name - I will not plug its name here, but I can say that it is not Bache, Halsey, Stuart Shields, members of the New York Stock Exchange and other leading exchanges! Like many of you, we have looked at this product - looked under the hood so to speak - to see what makes it tick.

Basically, there are four things. One is a certain degree of flexibility. Two is a high current interest crediting rate. Three is the assumption of more favorable tax treatment. And four is a generally lower sales load.

At this point I am reminded of the story of one of my associates who attended the recent International Congress of Actuaries in Switzerland. It was his first visit to Switzerland, so he toured around a bit. When he returned, I asked if he did not think it was a beautiful country. He said no, he was not at all impressed - take away the mountains and the lakes and there is really nothing left.

Now as to Universal Life, take away the flexibility, the high current interest rate, the tax advantage, and the lower expense load, and what have you got - not much.

But the fact is that these advantages may very well be temporary.

Flexibility, like the so-called drop-in feature? A number of companies are experimenting with special cash value and paid-up addition riders in conjunction with conventional policies. These do much the same thing as drop-ins but on firmer tax grounds.

Higher current yield? Let the interest rate yield curve revert to its traditional shape, not the so-called inverted form it now takes - hopefully a temporary aberration - and the high current yield will be a low current yield. If the companies offering Universal Life were to respond by investing long-term, they could expose themselves to problems of disintermediation and market value adjustments even worse than under traditional policies.

Tax advantage? Yes, Phase II-Negative companies may have a tax advantage when they credit excess interest - provided the U.S. IRS holds this not to be a dividend. Phase I companies like my own include their excess interest in the form of dividends, but these are only partly deductible. Thanks expecially to the workings of the Menge formula, the infamous 10-for-1 rule, dividends are less and less deductible as interest rates climb. If we cannot get relief from these ever more onerous tax burdens, the future of participating permanent life insurance may be cloudy indeed. It is up to us how vigorously and effectively we lobby for and obtain a reasonable tax law that is fair to all companies and to all forms of insurance.

Universal Life typically utilizes some form of downscaled commission levels. The sales load is less for larger policies. There is certainly no magic here. I do not know whether competitive conditions will require more traditional life insurance companies to downscale commissions on our products or not, but certainly this matter is in our hands too.

In other words, it is not inevitable that Universal Life will make traditional forms obsolete.

There are schools of thought taking the opposite view, who have such reverence for traditional permanent life insurance that they cannot conceive of its demise and who brush away all dangers. But its survival is no more inevitable than its death.

There is an important lesson to be learned from the history of the 10-for-1 rule. Back when the 1959 Tax Act was being framed, the life insurance companies and their actuaries supported this device for determining required interest rates in the tax calculations. It worked fine under the conditions prevailing in 1959; and, on the basis of seemingly reasonable projections into the future, it would continue to work fine. But the future behaved unreasonably, and the formula could not adapt to the unexpected.

We found 6% policy loan rates inadequate, so what did we do? We changed the limit incrementally to 8%. We found 4% reserve interest ceilings too restrictive, so we raised them to 4½%.

I think, however, that we actuaries and the insurance industry in general have learned from our experience. Now we are going for variable policy loan rates in the U.S. - you are ahead of us on that here in Canada - and for variable reserve and non-forfeiture rates. In each case, the legal maximum will depend on some external index, giving satisfactory results over a much broader range of possible circumstances.

The lesson is that, like any other creature, the permanent life insurance contract will survive and thrive only if it can adapt to rapidly changing circumstances. Arbitrary rigidities and other artificial burdens will kill it.

Clearly we are on the right track today. If we can obtain the necessary changes in the tax laws; if we continue to restructure our assets so that our returns are more responsive to changing financial markets; if we respond to the demands of the consumer marketplace; and if we unblock any other rigidities in the permanent life insurance contract, it will endure, but it is up to us to make that happen.

MR. STANLEY B. TULIN: In recent years we in the United States have watched our economy and our expectations of our economy change. We have lived through three years of double digit inflation and nearly two years of double digit interest. Disposable income of those in the lower and middle income brackets has decreased - in real terms - dramatically in the last fifteen years. Upper income decision making is now - more than ever before - linked with Federal Income Tax questions.

The impact of these changes in our external environment on the life insurance industry has also been dramatic. In 1973, 43% of new life insurance was term. In 1978, 52% of new life insurance was term. Term insurance rates are now at levels few of us would have believed possible even five years ago. Life insurance purchases in the middle class - once the model purchaser of permanent insurance - are turning to the inexpensive term because they cannot afford permanent insurance - their disposable income is less - and because there is either an explicit or implicit understanding that the increasing cost of term insurance will be offset in years to come by inflation.

Last year, when interest rates soared to record levels, many companies were faced with negative cash flow as policyholders moved to surrender for cash or borrow. This negative cash flow came at a time when the market value of long term bond and mortgage portfolios was in some cases as low as 65% of amortized book. Liquidating securities - at substantial capital losses - would have impaired the surplus of many of these companies, and consequently, the life insurance industry found itself borrowing money to meet the loan demand of its policyholders.

Returning to the external environment, money-market funds have made it possible for small investors to earn double digit rates of interest which - conceptually at least - make the old adage, buy term and invest the rest, sound more attractive.

What is the industry doing? Essentially, I believe we are developing products which buy term and invest the rest. Retired Life Reserves products - which a number of U.S. companies have had substantial success in selling, have, typically, very competitive annual renewable term scales sold in conjunction with new money oriented funding vehicles. Some mutual companies have gone to new money oriented dividend scales by allocating investment income to generations of policyholders using the investment year method.

In the last two years a new product has surfaced - combining the buy term and invest the rest into one product which is tax sheltered from the buyer's point of view. This product is the so-called Universal Life. New Universal Life products are hitting the marketplace each week as additional companies develop them. The first such product was E.F. Hutton's "Complete Life", which is approximately two years old. Recently Occidental Life has introduced "T-Plan" Life and The Hartford has introduced "The Solution". Perhaps The Hartford's name best reflects the hopes of many in the industry today. As an example of this type of product, T-Plan Life permits intermittent premium payments. When a premium is paid, a 10% charge for expenses is deducted with the balance of the premium going into the "Cash Value". Each month a charge for the term insurance is made. The term charges are Annually Renewable Term-Type rates, i.e., they increase each year with attained age. Cash values are accumulated at interest rates based on current yields on 13 week Treasury Bills. Partial surrenders and policy loans are permitted. However, amounts outstanding as policy loans are credited with the guaranteed rate (3%) rather than the T-Bill rate. The Face Amount may be increased (with evidence of insurability) or decreased. Depending on the option elected by the policyholder, the death benefit may increase with increases in the cash value.

The following material is an example of a hypothetical Universal Life product. In this example the face amount - that is, the death benefit - is constant, and so the amount at risk decreases from year to year. This example assumes that the mortality charge is made monthly, the full gross premium is paid at the beginning of the policy year and that expenses are charged throughout the year. Gross interest credited to the account is calculated at 10%. This product has a 7.5% assumed annual loading as well as some additional costs at issue. Also included in the expenses is the difference between the 10% credited rate and the 4% guaranteed rate on the first $1,000 cash value. The mortality charge is assumed to be applied monthly based on an underlying scale of q's and the net amount at risk. In this example the premium and amount are constant, and there were no loans or partial surrenders. In practice, the amounts can vary, and the premiums

FLEXIBLE PREMIUM LIFE INSURANCE
POLICYHOLDER ACCOUNT
AGE 45 - 4.00/10.00 PERCENT NET

(1) POLICY YEAR	(2) FACE AMOUNT	(3) INITIAL FUND	(4) GROSS PREMIUMS	(5) GROSS INTEREST	(6) EXPENSES	(7) MORTALITY CHARGE	(8) POLICY LOANS	(9) GROSS PARTIAL SURRENDER	(10) ENDING FUND
1	100000.00	0.00	2300.00	174.81	591.45	424.78	0.00	0.00	1458.59
2	100000.00	1458.59	2300.00	336.16	231.45	440.70	0.00	0.00	3422.60
3	100000.00	3422.60	2300.00	531.43	231.45	465.47	0.00	0.00	5557.12
4	100000.00	5557.12	2300.00	743.33	231.45	499.87	0.00	0.00	7869.14
5	100000.00	7869.14	2300.00	973.20	231.45	529.16	0.00	0.00	10381.74
6	100000.00	10381.74	2300.00	1223.25	231.45	555.70	0.00	0.00	13117.84
7	100000.00	13117.84	2300.00	1496.30	231.45	567.91	0.00	0.00	16114.78
8	100000.00	16114.78	2300.00	1795.12	231.45	586.72	0.00	0.00	19391.74
9	100000.00	19391.74	2300.00	2122.26	231.45	598.58	0.00	0.00	22983.97
10	100000.00	22983.97	2300.00	2481.15	231.45	605.23	0.00	0.00	26928.44
15	100000.00	46917.26	2300.00	4873.63	231.45	617.17	0.00	0.00	53242.27
20	100000.00	86217.90	2300.00	8823.84	231.45	148.23	0.00	0.00	96962.06

FLEXIBLE PREMIUM LIFE INSURANCE
EXPENSES AND CHARGES
AGE 45 - 4.00/10.00 PERCENT NET

(1) POLICY YEAR	(2) PREMIUM LOADING	(3) OTHER EXPENSES	(4) INTEREST REDUCTION EXPENSE	(5) INTEREST REDUCTION RISK	(6) INTEREST REDUCTION TAX	(7) TRANSACTION CHARGE	(8) TOTAL EXPENSE	(9) SURRENDER CHARGE
1	172.50	360.00	58.95	0.00	0.00	0.00	591.45	0.00
2	172.50	0.00	58.95	0.00	0.00	0.00	231.45	0.00
3	172.50	0.00	58.95	0.00	0.00	0.00	231.45	0.00
4	172.50	0.00	58.95	0.00	0.00	0.00	231.45	0.00
5	172.50	0.00	58.95	0.00	0.00	0.00	231.45	0.00
6	172.50	0.00	58.95	0.00	0.00	0.00	231.45	0.00
7	172.50	0.00	58.95	0.00	0.00	0.00	231.45	0.00
8	172.50	0.00	58.95	0.00	0.00	0.00	231.45	0.00
9	172.50	0.00	58.95	0.00	0.00	0.00	231.45	0.00
10	172.50	0.00	58.95	0.00	0.00	0.00	231.45	0.00
15	172.50	0.00	58.95	0.00	0.00	0.00	231.45	0.00
20	172.50	0.00	58.95	0.00	0.00	0.00	231.45	0.00

FLEXIBLE PREMIUM LIFE INSURANCE
DATA INPUT
AGE 45 - 4.00/10.00 PERCENT NET

LUMP SUM PREMIUM LOADING	0.0000
POLICYHOLDER ACCOUNT INTEREST BREAKPOINT	1000.0000
INTEREST ADJUSTED NET COST RATE	0.1000
FACE AMOUNT MODULE	1.0000
OTHER EXPENSE - FRONT END FLAT AMOUNT	0.0000

YEAR	LOADING	PERIODS	SURRENDER CHARGE	LAPSE AMOUNTS	RISK AMOUNTS	DEATH RATES	GROSS INTEREST RATES		NET INTEREST RATES		RISK CHARGE	OTHER EXPENSE FLAT	OTHER EXPENSE PER 1000
1	0.07500	12	0.0000	0.00	0.00	0.00431	0.1000	0.1000	0.0400	0.1000	0.0000	252.00	1.08
2	0.07500	12	0.0000	0.00	0.00	0.00455	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
3	0.07500	12	0.0000	0.00	0.00	0.00491	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
4	0.07500	12	0.0000	0.00	0.00	0.00540	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
5	0.07500	12	0.0000	0.00	0.00	0.00587	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
6	0.07500	12	0.0000	0.00	0.00	0.00635	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
7	0.07500	12	0.0000	0.00	0.00	0.00671	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
8	0.07500	12	0.0000	0.00	0.00	0.00720	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
9	0.07500	12	0.0000	0.00	0.00	0.00767	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
10	0.07500	12	0.0000	0.00	0.00	0.00815	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
11	0.07500	12	0.0000	0.00	0.00	0.00887	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
12	0.07500	12	0.0000	0.00	0.00	0.00971	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
13	0.07500	12	0.0000	0.00	0.00	0.01067	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
14	0.07500	12	0.0000	0.00	0.00	0.01163	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
15	0.07500	12	0.0000	0.00	0.00	0.01258	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
16	0.07500	12	0.0000	0.00	0.00	0.01367	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
17	0.07500	12	0.0000	0.00	0.00	0.01498	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
18	0.07500	12	0.0000	0.00	0.00	0.01643	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
19	0.07500	12	0.0000	0.00	0.00	0.01798	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00
20	0.07500	12	0.0000	0.00	0.00	0.01990	0.1000	0.1000	0.0400	0.1000	0.0000	0.00	0.00

can stop and go as well as jump up and down; however, the basic operation of the product is the same.

T-Plan, and plans like it, offer flexibility, a competitive interest rate, and an attractive after-tax return to the buyers.

The Wall Street Journal, in a back page article several weeks ago, discussed Universal Life Products, Variable Life and traditional permanent insurance - both participating and non-participating. The Journal's comparisons showed the Universal and Variable Life products to great advantage. Of course, a critical aspect of the illustrations - for both Universal and Variable - is the assumed rate of interest. The Wall Street Journal article assumed a rate of approximately 11% for the Universal Life and Variable Life illustrations.

If interest rates remain at such high levels over a twenty year period, the dividends of the Mutual Company in the Journal comparison will increase. My point is that comparisons on Universal Life with alternative products will be difficult to do on a consistent basis. In an attempt to perform a fair comparison we compared the net payment, net cost, and ledger statements of a Universal Life product assumed to be crediting 7% with a very competitive mutual company whose 1980 dividend scale presumably reflected their 1979 earned rate of 7.4% - the mutual company does not use the IYM to allocate interest among generations within its ordinary life. We found that on this basis the two products were a toss-up on net cost at 5%. At a higher net cost interest rate the Universal would be superior. On balance, the advantage seemed to go to Universal Life. The major advantage seems to be the flexibility. As an example, consider that in the traditional whole life contract the relative amounts of savings and insurance are essentially fixed, whereas in a Universal Life the insured has a wide range of options with respect to the portion of premium going to insurance as opposed to savings.

Universal Life is still new, and all of us have different ideas about where it will lead us. I believe that:

1. In the same way that we have witnessed a term insurance rate contest in recent years, we will witness a Universal Life competitive contest in the next five years. Many medium and large sized mutual companies are planning to enter this market - probably through stock subsidiaries, and the result, ultimately, will be a profit margin squeeze.

2. Life insurance company investment strategies will become more important than ever. Companies will have to tailor their investment strategies to meet the guarantees in their own contracts and to protect against the risks of disintermediation. In recent years life company portfolios have changed, and I believe the next few years will see more change.

   Because of the profit margin squeeze, management, actuaries and investment personnel will have to work even more closely to maintain profits.

3. The Federal Income Tax treatment - from the life company point of view - will be a major issue in the next several years, as the questions regarding excess interest are clarified. If the tax issues - from the life company point of view - are lost, the attractiveness of the product will suffer because credited rates will necessarily be reduced.

4. Administration of Universal Life policies will prove to be challenging as competitive forces diminish profit and expense margins. As an example, consider the administration of a T-Plan which must credit thirteen week T-Bill rates on a revolving basis from date of deposit to date of withdrawal. Such administrative needs are not new to companies in the IPG or Guaranteed Investment Contract markets but will be new for medium - and even large - companies not previously exposed to retrospective accumulations. Companies will also need a precise basis for determining investment rates of return by generation of deposit in order to credit interest fairly, and to avoid providing investment selection opportunities to the insureds.

5. Lapse/Policy Loan. Last year's surrender and policy loan activity offered more than a hint of the public's ability and inclination to select against the industry on the basis of interest. As Universal Life products and differing investment philosophies proliferate, I believe we will witness more investment selection. We will, I suspect, find a direct relationship between our credited rates, surrender charges and available investment alternatives.

6. Replacement. As more companies enter this market and the products become more and more competitive, we will see substantial replacement - both of one Universal Life product to a different one or from an existing permanent product to a Universal Life product.

7. Commissions. The field will have mixed emotions. They will find Universal Life products easier to sell - at least initially - than their current permanent products. However, commission income as a percentage of new premium income will be lower, and consequently, agents will have to write much more premiums to maintain current income levels.

MR. DAVID R. JOHNSTON: I would like to try to answer this question from the Canadian perspective, because I feel the situation is different than in the United States, in regard to a number of factors.

1. What is the current situation?

   First of all, I have some figures to try to describe what the phrase "as we know it" means in Canada.

   At the end of 1980, cash value insurance was 47% of all individual insurance, based on amounts, i.e., just under half. Based on a small survey I did, over 80% of cash value insurance is participating. Also, about 75% is whole life, both par and non-par, heavily the former. So what we have in total in Canada is about 60% par whole life and about 15% non-par whole life, with most of the rest being other participating life and endowment.

There is almost no permanent non-par insurance in force other than whole life. Most of the insurance in force is of the so-called traditional type, although in the last five or six years there have been a number of innovations in the non-par life area that I will mention later.

2. <u>What have been recent trends?</u>
Over the last five years the percentage of total insurance in force on a permanent or cash value basis has dropped from 56% to 47%, despite the fact that a few companies actually increased their proportion of permanent insurance, due to product innovations, or for other reasons. The proportion of new issues which are permanent insurance, dropped over the same five year period from 41% to 30%, again despite some companies bucking the trend. Twenty years ago nearly 60% of sales were on permanent plans, so this has been cut steadily to half over that period.

With these significant drops in permanent amounts in sales, it is clear the amount of permanent insurance in force will continue to decline. However, I think in Canada there is some evidence that the proportion of new sales on permanent plans is tending to level off, and cash value insurance, in one form or another, may continue to be a significant factor for some time.

3. I would like to comment on a few factors that have a bearing on the possible viability of permanent insurance.

(1) <u>One factor is that of policy loans.</u>
The proportion of policy loans taken out in Canada has not been as high as in the United States. For example, in my company, 36% of the total loanable amounts available have been loaned on U.S. policies, whereas only 19% have been loaned on Canadian policies.

Since we have had variable rates of loan interest in Canada for 12 years, and since the United States is now moving toward variable rates, the Canadian experience may be interesting.

Until the late 1960's, it was common to have a 6% loan interest rate in Canada and 5% in the United States. During the 1970's, variable rates have been used in Canada, while 6% has been common in the United States.

I looked at our company's loans broken down by size of loan, in these four interest rate categories - 5% and 6% in the United States and 6% and variable in Canada. There was a surprising similarity to the utilization rates for a given size of loan, in all four categories, particularly if I looked just at policies with loans.

For policies with loans, the percent of loan value loaned graded smoothly from about 40% for the smallest sized loans, to 70-80% for the largest sized loans, with about the same percents in all interest rate categories in both countries.

However, looking at all policies, there was clearly a greater percent with no loan on the variable category in Canada, but this was also true for 6% loans in the United States.

Our company's lower overall proportion loaned in Canada seems to be mainly a function of smaller average sized policies in Canada, and also somewhat lower ratios for the very largest sized policies where tax differences in the two countries probably are more important. This implies that the variable rates have so far not acted as a very big deterrent; however, this may relate to the fact that typical variable rates over the 1970's in Canada were not that much different than the old 6% rate - perhaps 8-10% being typical. Now that variable interest rates are around 15% in Canada, we may well see relatively lower utilization rates on these policies.

It is important to note that, even after 12 years, we still have twice as much possible loan value on the old 6% rates as on the variable rates, so the affect of changing loan procedures on new policies is very slow to become apparent.

In summary, it seems to me that heavy loan utilization will be a problem in the near future; but, even though I do not feel there is a great deal of hard evidence so far, it seems clear the use of variable loan rates which are quite a bit above old guaranteed levels should help the situation. This alleviation will be apparent much more quickly in Canada than in the United States due to the deferred affect.

(ii) Regulatory Climate

The regulatory climate in Canada has a number of factors which make it more hospitable to permanent insurance than that in the United States.

For example,

- there is no requirement to have cash values in insurance policies let alone any particular minimum.
- there is no requirement for loan values in policies.
- variable loan interest rates are allowed.
- there is no active approval mechanism for policy forms, allowing innovative products to be brought to fruition more easily.
- policy liability reserve requirements are quite reasonable and are relatively free from extra conservatism. Reserve bases reflect the return on assets which should allow the company to tailor investment policy to benefits provided.
- the tax situation does not cause problems for permanent insurance.

Under these circumstances, it should be possible to design permament insurance products in Canada which minimize some of the problems of permanent insurance more easily than in the United States.

(iii) Product Development

I would like to comment on some of the products that have been developed in Canada in recent years that kept the proportion of permanent insurance as high as it is. Some companies who have taken the opportunity to design marketable permanent plans have produced significantly more permanent business than they would have otherwise.

(a) Non-guaranteed Products

A major problem with traditional non-participating permanent insurance in today's fluctuating conditions is that it is impossible to provide full guarantees at a price conservative enough for the company, yet competitive enough for the client. This has been solved by not providing guarantees of some aspects of the policy. My company developed a very saleable permanent non-par product in 1972, merely by removing the guarantee from the premium, allowing the conservatism usually found in non-par premiums to be removed. Other companies in Canada have made various benefits, including the death benefit, partially non-guaranteed. Making the cash value non-guaranteed minimizes the surrender and replacement problem.

(b) New Money Products

Simple removal of guarantees may not be attractive enough to a client who is concerned about the investment aspect of his contract and wants to see a good return relative to investments in other financial institutions. This, of course, is the major policyholder problem with permanent insurance generally.

Several companies in Canada have combined non-guaranteed features with new money assumptions in the pricing of the permanent product. This produces a very competitive looking cost.

(c) As one type of new money, non-guaranteed pricing, some companies have produced single premium products. These emphasize the new money aspect. A problem with these contracts is replacements - of either your own policies or other companies. In times of high interest rates, it appears that neither existing par nor non-par contracts can compete with using guaranteed surrender values to buy a new single premium contract on a new money basis. This is an obvious problem if your company has a substantial block of in force business with high guaranteed cash values.

(d) One way of counteracting the replacement affect on a company's block of old policies is to make ad hoc improvements to existing business. Three large companies in Canada made such improvements in their policies this past winter by unilaterally increasing death benefits. This occurred on both par and non-par policies. I presume an important factor in their decision was to minimize replacements. No doubt these actions also tended to improve their policyholders' expectations of their products generally.

4. Conclusion

In Canada, cash value insurance has a relatively hospitable climate in which to survive. Important factors are a regulatory situation which does not require guaranteed values and has allowed variable loan rates for some time, and the development of innovative products. Nonetheless, the proportion of permanent insurance in force has been dropping and will continue to drop for some time.

I expect that further elimination of guarantees will happen and that more companies will adopt products with new money pricing. The thrust of new money products is to show a good return on the savings part of the premium, recognizing that the competition is other financial institutions, not other insurance companies. This sort of thinking leads to the Universal Life style product which is very saleable in an economic climate such as the current one if it can be packaged properly and if the renumeration problems can be solved. It will be natural to have low commissions on the savings portion in order to compete against the true competition. In Canada, we have found this result in the R.R.S.P. market where we were competing against trust companies and banks.

So, the answer to the question perhaps depends on what kind of cash value insurance one has in mind. Cash value insurance in Canada has been changing in character with its loss of guarantees, and emphasis on new money pricing, and will continue to change in the future. When the favorable regulatory climate and various defensive actions of companies are taken into account, cash value insurance should survive but on a more limited basis and with different products than in the past.

MR. PETER F. CHAPMAN: I think any comments on the life expectancy of permanent insurance cannot be separated from the evaluation of the life expectancy of the agency system. As the first two speakers made very clear, part of the appeal of the alternative forms of permanent insurance rests on a low commission base. I have made some calculations based on the development of agents' income and based on the most recent agents' continuance tables available from LIMRA. If that kind of commission scale is necessary for a viable permanent product, then the relationship between the two systems - the agency system and permanent insurance - is not encouraging.

MR. TULIN: I agree with what Peter is saying. We have done some calculations to compare, for $100,000 face amounts, the products of three different companies. The first year compensation is cloudy, because it is split, but it works out to something that ranges from a low of 20% of premium to a high of 35% or 40%, no higher. I have always thought that part of the reason that we were trying so hard to have a future for permanent life insurance is to keep our agencies alive. And they have always been clamoring for good permanent products that give them good commissions and high income. I do not think this product is going to do so, which is the reason why I am not optimistic about it.

MR. ROGER W. SMITH: I think some of the comments were rather inward looking, comparing Universal Life with traditional permanent. I think that, as an industry, we have to be more outward looking. The tremendous rise of the money market accounts has done a lot to bring about products like Universal Life. Until we look at some of the other possibilities for savings dollars, I am not sure that permanent life is going to survive.

MR. MARGOLIN: It is certainly true that there has been an explosion in money markets funds. That is almost entirely because short term interest rates have tended to exceed long term rates. Perhaps the situation will continue, but perhaps not. The yield curve traditionally was lower for short term than for long term. Now it is inverted. If this is a permanent change, that holds one thing for permanent insurance. If it is a temporary aberration and the yield curve goes back to its traditional form, that holds something quite different. This is one of the reasons why I feel there is no inevitability about anything. A lot depends on the economy, and a lot depends on us.

MR. EDWARD T. HILL: As I look at the example that has been spread before me, I think about the pressure from the IRS for taxation of the inside build-up in life insurance companies. With this new product we say in effect to a policyholder: "You have paid us so much money. Part of it is used for term insurance and expenses; the rest of it is accumulated with interest." I wonder if the IRS is likely then to say: "You do not have one contract here. You have two contracts. You have a contract under which you provide term insurance. You have an investment certificate under which there is some kind of accumulation with interest payable annually. We think that your interest should be taxable annually." Is there talk of that kind at all with the development of these kinds of contracts?

MR. MARGOLIN: I do not think that anyone knows what the ultimate tax status of these products will be. A number of companies have applied for private letter rulings from the IRS. The only one that has gotten a ruling and has divulged it is E.F. Hutton on its Complete Life product, where the request had to do with the tax consequences to the policyholder. That is what you are alluding to. The question of the tax implications for the company is still unresolved. The IRS did issue what is a more-or-less favorable ruling based on the facts that Hutton gave them. Namely, that there would be no currently taxable income to the policyholder and that the entire proceeds, both the savings portion and the term insurance portion, would be considered as death benefits in the case of death. Obviously there would be taxation of the taxable gains on surrender in the usual way. As in so many cases, however, the IRS may reconsider. There is a story of someone who bought a policy with a $10,000 term insurance benefit and a million dollars of cash value. On death will all the $1 million and $10,000 be considered death benefit? I would not want to rely that it would be.

MR. TULIN: I read the Hutton ruling. It seemed favorable from the point of view of the insurer, but it is just a private letter ruling. The second part of that private letter ruling only hinted what might happen from the insurance company point of view. In effect it said, "You have told us all these things about what this product is. On the basis of that, we are going to rule favorable on the tax consequences to the insured, but the tax consequences to the company with respect excess interest may not be quite as favorable."

MR. CHAPMAN: That is true. My understanding is that Merrill Lynch is waiting for a private letter ruling on something that challenges the issue more dramatically. They are issuing a Universal Life policy with a variable death benefit tied to a number of separate accounts, each of which is managed by Merrill Lynch. It is a case of having, on the one hand, a variable benefit tied to a separate account and, on the other hand, an additional amount of term insurance - a combination of Universal Life and variable life. That private letter ruling will be informative!

MR. RICHARD E. OSTUW: I do not perceive the inversion of the yield curve as overpowering. With the use of the investment generation concept for Universal Life, as we have seen for annuities, companies can structure their investment strategy and their guarantees so as to be able to shift into long term investments where that strategy is warranted.

MR. MARGOLIN: The point is that the current apparent advantage in interest crediting derives from the fact that the current short term money rate is higher than the long term portfolio rates that other companies are now using as a basis for their dividends. If the yield curve does invert, and portfolio rates catch up to new money rates, the advantage will lie with the long term investor. That is a job that the traditional life insurance companies have been doing quite well.

MR. WALTER N. MILLER: I have three comments. The first is on the Merrill Lynch product. As some of us read their prospectus, it is not a Universal Life product. It is rather something akin to the Equitable design of a variable life policy as proposed originally by Harry Walker in his discussion of our 1969 paper. This sort of variable life design has received some solid tax rulings. 79-87 is one of them from the policyowner standpoint. What happens with the Merrill Lynch ruling request may have little to do with the ultimate outcome of Universal Life.

The second comment is on the agency system and Universal Life and permanent insurance and so on. It has been very well stated by some of the panelists that, to the extent permanent life insurance, traditional and non-traditional, has any future at all, that future is likely concentrated in middle and upper bracket markets. The future will depend on demonstrating that permanent life insurance, or some variant thereof, produces tax advantages that are unique vs. other financial instruments. If there is anybody in this room who thinks that you can sell this kind of product with that sort of appeal, and make those demonstrations in sophisticated markets by mail, he is crazy. The only way that product can be successfully sold that way in those markets is by knowledgeable, trained life insurance agents who, as everybody knows, make up part, but not all, of our current field forces.

Therefore, if the agency system is headed down the tube, as was suggested before, then our sales of traditional permanent life insurance in those markets are headed down the tube also, because we are going to lose the only people who have the knowledge and contacts to sell it. I am not so gloomy. I believe that what we are going to see is a reasonable accommodation between the commission levels that have been traditional for permanent life insurance and the commission levels that some people are talking about for Universal Life products. Remember that the Universal Life products we see on the market now, the early ones, are largely not being sold through traditional field forces.

There is going to be some sort of marriage. There is going to be a lot of interesting work in developing other innovative compensation systems. Commissions do not have to be all of an agent's income, especially one who can qualify and convince clients that he operates as a professional. In these markets, he can do a lot on a fee-for-service basis.

Third, of great significance in the present and the future of permanent life insurance, is the fact that right now it is a much cheaper product than term for anyone in a reasonably high tax bracket who buys a par policy and fully loan finances it. I do not see much in the future of sales of permanent insurance except on a pretty heavily loan financed basis. If the leverage is there, upper bracket par clients and prospects are going to take advantage of it. That is a fact of life.

MR. TULIN: I agree with everything in that comment. If you sell permanent life insurance with the cash values fully loaned, you simply mimic term. I think that the illustration also mimics term, except for the tax consequences.

MR. CHRISTIAN J. DESROCHERS: We at the Hartford feel that eventually there needs to be a reasonable relationship between the premium and the amount of insurance. The IRS has a request about a product which allows an annual deposit of $25,000. We do not think they are going to permit that. The second half of the E.F. Hutton private letter ruling exposes the unwillingness of the company tax people in the IRS to take a stand one way or the other. They did not really say whether it was par or non-par or exactly what it was. That was intentional, so as to leave their options open.

MR. BENJAMIN H. MITCHELL: The question here today is,"Is there a future for permanent life insurance, and if so what is it?" Two things that seem important to the future of permanent life insurance and the sort of insurance it might be come to mind. If we have permanent life insurance, it is because we want a savings element in the contract. To have a viable savings element, there is a requirement for some form of relatively efficient interest through-put on that savings element. That depends on the income tax treatment and the load tolerance of the product. If you want to buy protection, the insurance industry is the only place you can get it, and the load tolerance of the protection element in the contract is probably quite high. On the other hand, the load tolerance on the investment side of the permanent life insurance contract has to be at a level where it can coexist with other competing investment opportunities, so there is lower tolerance for load on the investment side than on the protection side.

Our existing permanent policies were developed in an environment of typical surburbia - a wife, two kids, a stationwagon and a dog. Statistics today indicate that a young man coming out of college may have an expectation of more wives than children. The rigid policies of the past are not going to react very well to that.

Universal Life is a current product that tries to give some recognition to the new situation. I suspect we will see others in the future.

MR. MARGOLIN: I question the premise that, if we want to have a permanent insurance contract or if the public wants to have a permanent insurance contract, it is so that there can be a savings element. Here we are getting into the area of consumer psychology and what the consumer is looking for. In many instances the consumer wants simply permanence - permanence with a guarantee. He does not in many cases find that with YRT or other term products, which may be renewable for a very long period of time, but which do not appear to him to be permanent. You may or may not feel that the consumer is rational in this perception or this desire, but surveys indicate that a large percentage of consumers do want this permanence.

MR. TULIN: I believe that is true. It would be great if we could do away with some of the things that Elizur Wright did to us. We could, for instance, then develop a product closer to level premium term insurance, with reserves but with no cash values or with very low cash values. That would cost less than traditional permanent insurance but give insureds its permanence and the comfort of not having to worry about increasing premium with age.

MR. JESSE M. SCHWARTZ: Why are people so reluctant to call Total Life permanent insurance? The formula for the reserve at the end of any year is the initial reserve plus interest less the cost of insurance. In effect that is what Total Life does. Mike indicated that insurance will survive if the necessary tax law revisions can be obtained. It would seem that Total Life does this except for some question of the tax treatment. One of the important things which Total Life has introduced is the recognition, at the policyowner level, of actual loan utilization rates.

MR. MARGOLIN: The question I was responding to was whether the cash value life insurance product as we know it will survive. I took that to mean the traditional product. Universal Life type products are, I suppose, permanent. It is a semantic question whether they are permanent life or not, but clearly they are not the traditional cash value products as we have known them and that was what I was addressing.

MR. CLARK: Perhaps I can raise a question. I first became acquainted with this Universal Life product from a paper by Jim Anderson at the Pacific Insurance Conference half a dozen years ago. He predicted a number of things. First, that the product would take off. Second, that it would reduce the present number of life insurance companies and agents in the United States to one third or one quarter of what we now have. He was kind enough not to make any prediction about the number of actuaries! Stan, if the product does take off, is that consequence going to result?

MR. TULIN: I think it might, but not for the reasons in that paper, which I too remember. My concern about this product, assuming that it takes off, and I think it is going to, is the substantial price competition. If you look at the product designs and see how much of the investment income is being passed back to the insured, you will see that there is not much margin for the company to recoup acquisition costs and make a contribution to surplus in the case of mutual companies, or pay dividends to shareholders in the case of stock companies. I believe that companies will play investment games. Take T-Plan Life as an example. T-Plan Life is immunized or close to immunized if all the money obtained is invested in treasury bills with 13 week maturities. There would not be much in the way of investment margin if that is done. I think it is only a matter of time before the idea of investing in something else is considered. Maybe the market has peaked, and T-Bill rates are going to go down. Now is the time to dive in and maximize our yields by going long term. Competition may force companies to mis-match. Some of them will guess wrong. The ones that guess wrong may go under. This will be similar to the disintermediation that hit the industry last year - except that the disintermediation was merely a timing problem. On this thing, a wrong guess is more than a timing problem. The money that has to be credited is not available. We are going to see failing companies.

MR. DAVID MILLAR: So far, we seem to have concentrated on adjustable life. Does the panel suggest that this is the only way we are going to sell permanent insurance in the future? If there is a choice to the consumer, how do you educate both the consumer and the field force to distinguish between the choices?

MR. MARGOLIN: I did not intend to imply that the only way we will be selling insurance is through adjustable life. There are semantic problems here. "Adjustable life" used to apply to the specific product that Bankers of Iowa and Minnesota Mutual had. That product had many characteristics of the traditional cash value policy. Some use the expression "adjustable life" to apply to Universal Life products. I do not know whether you meant to apply adjustable life to those. In any case, I was suggesting that there have been some rigidities in the traditional product, that some of those rigidities have hurt us, like the 6% policy loan ceilings, and like the rigidities in the income tax formula. We have got to get rid of these rigidities.

If we want to be able to sell something like the traditional product for many years in the future, and want the product, once it is sold, to remain in force for many years thereafter, we are talking about very long spans of time. There are bound to be changes. The product ought to be designed in such a way that it will hold its value to the policyowner. It has got to be flexible, and to the extent that it needs more flexibility, it should get it. I do not think that the only way to obtain that flexibility is through the Universal Life route. I think that there is at least considerable promise that we can do it through something more nearly like the traditional product. But it is up to us. We have got to be creative and we have got to get the necessary help in some areas from the federal government. I am thinking particularly of tax changes.

MR. MILLER: Stan's remarks on the indexed product and the T-Plan type of product where you guarantee that the yield will be that of a specific instrument are well taken. These products are not applicable only to Universal Life type of design. They are just as applicable to modifications of the traditional life insurance products. In the United Kingdom, for years benefits in some products have been linked to a specific index. Companies now play the game, "Let's beat the index with our investments." The situation there is volatile. There were a couple of interesting bankruptcies. I do not know what the regulatory situation is now in the United States. About ten years ago, this concept was talked about in connection with the variable life product. Regulators were saying that mis-matching was something that they would never allow or would only allow under very tightly controlled conditions.

MR. MARGOLIN: There is one other problem with the proliferation of the Universal Life product, namely, a scarcity of names. The product began as Total Life, then we have Complete Life, then Universal Life, and now Ultimate Life. Now what have you beyond Ultimate Life, except Eternal Life!

MR. RICHARD J. SQUIRES: I am from Save & Prosper Group in London, the largest unit trust group in England. That is equivalent to your mutual funds. The company was started specifically as a sales outlet for the unit trust. My initial instructions were not to meddle with designing policies that did not involve unit trusts. It has changed a bit since then. I thought you might be interested to know that the original basis of the development of the unit linked contract was a market demand for three things. We saw a demand for participation in the equity boom that was going on. We saw a demand for people to be able to choose their investments. We also saw criticism because companies did not disclose the charges they were making. We saw criticism because people did not know whether they were getting their fair share of the surplus the insurance company made. People were saying, "Okay, so I have a policy, it guarantees so much, and I end up with the guaranteed sum and a bonus of so much, how do I know whether you have given me my fair share of what the company has made? How do I know how much you have tucked away in a back corner or spend on oak paneling in the Board room or on a Rolls Royce for the Directors or whatever?"

The unit product answered that demand and that criticism. It told the customer how much of the premium is invested and what it is invested in. He would work it out for himself by looking at the price in the newspaper. He could choose the investment medium.

All went well up to 1974, when the stock market caught a cold. The sales force came back to us and said, "Look, people are saying, you choose the investment vehicle for me. I do not want to choose my own investment vehicle." We have actually now gone into the phase where we are designing pseudo-conventional contracts which look like conventional contracts on the outside, by providing a guaranteed sum assured for a fixed premium, and with a terminal bonus, but the terminal bonus is determined by the value of an internal fund, which we run for each customer, which is linked to a portfolio of investments, which we choose to produce the guaranteed sum assured and then to make as much money as possible thereafter.

MR. CHRISTOPHER H. WAIN: A company selling whole life insurance is like a university of life insurance selling, providing a course of instructions in which they pay the students under some circumstances and incur tremendous cost for every person graduated. If those universities did not have that cost, one of the disadvantages they suffer in recouping the Universal Life expense level would disappear. Perhaps there is something in our future that will make it possible for the successful graduates of one of these universities of selling to reimburse the university, or get reimbursement from his new employer, for these expenses.

MR. TULIN: I think there are really two issues, and we should try to separate them. One issue on the taxation side is the taxation from one life company to another. There is no question that that is going to get thrashed out much the same way it got thrashed out 20 years ago. About a year ago I was on a panel involving tax, and I remember Walt Miller asking me a question about the likelihood of this whole tax question getting resolved in our lifetimes or something like that, and I remember saying that I thought that there probably will be a panel in 1990 discussing the implications of the proposed law. I still believe that, which is to say that I do not see any resolution to the tax question within the industry in the short term. There is going to be one or two fiats from the IRS. They are apt to contradict themselves once in awhile, which they have done in the past, and I think we are all going to be confused for the next few years.

The other issue which is also important is the issue of taxation in these various contracts and the impact of that on the insured. The E.F. Hutton private letter ruling does a lot to clarify the implications of taxation on Complete Life to the insured. I think there are fewer questions on indeterminant premiums, and I think about these two questions. One concerns the taxation of the industry and the other concerns the taxation of the insured. They have different implications in terms of the future of permanent life. One asks whether or not mutual companies, as opposed to stock companies, will have success in selling it. Whether or not mutual companies, for instance, will have to start stock subsidiaries in order to sell it. The other question asks whether or not the insurance industry as a whole will be able to compete with the money market funds and with other vendors out there selling savings instruments and still get savings dollars. I am not convinced that this is a great thing to do. I think that maybe the things we have to give up to get those savings dollars are more than it is worth to have them. I really believe that there are two big questions here, one of which affects companies within one industry and the other which affects the industry as a whole as it competes with other industries.