RECORD OF SOCIETY OF ACTUARIES
1981 VOL. 7 NO. 3

THE LIFE INSURANCE BUSINESS—THE VIEW OF CONSUMERISTS

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What complaints or criticisms do consumerists have of the life insurance business and its products? A non-actuary who has studied life insurance will outline where the weaknesses are and suggest what should be done to correct them. An actuary will present views from inside the industry. The third panelist will comment on the others' views, suggesting where either side is off base or could improve.

MR. DANIEL F. CASE: The topics which we are going to discuss today were chosen, as was promised, by our consumerist, Mr. Belth, and he is going to list them for you before we launch into our discussion of those topics.

MR. JOSEPH M. BELTH: I wish to point out that I, too, am a consumer of life insurance as well as, on occasion, a speaker for the consumer's point of view. A few years ago a prominent life insurance agent made this particular comment, "I personally think that any insurance organization putting Joe Belth on a platform is out of its mind. Anyone who buys his books and subsidizes his garbage should have his head examined." And then there was a prominent life insurance company home office official who said, "I despise the guys who minimize and criticize the other guys whose enterprise has made them rise above the guys who criticize."

Anyway, with such comments in circulation I am very pleased to have been given the opportunity to share some ideas with you. I would like to state briefly my views on several topics. Many of you probably have misconceptions about where I stand on these matters.

First, on life insurance itself, there is no substitute for life insurance because there is no other legal way to make up the difference between a person's financial objectives and the person's accumulated financial resources in the event of his or her death. There are illegal ways, such as robbing a bank or printing money, but there is no other legal way to make up the difference.

On disclosure to consumers, I favor a mandatory uniform, rigorous system of information disclosure to buyers of life insurance and to owners of existing policies. I am opposed to expense regulation, and I am opposed to price regulation. I favor maximum freedom for life insurance companies in pricing and design together with rigorous disclosure, so that the marketplace can eliminate high-priced and manipulated policies.

On term vs. cash value life insurance, I am neutral. Term insurance has its place, and cash value insurance has its place. It all depends on the financial circumstances and objectives of the buyer. I deplore deceptive sales practices employed by advocates of term insurance, and I deplore deceptive sales practices employed by advocates of cash value insurance.

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On state vs. federal regulation in the U.S., I have no position. I am an insurance professor, not a political scientist. State regulation has serious shortcomings, but I do not know if federal regulation would be any better.

In the famous Federal Trade Commission Staff Report on Life Insurance Cost Disclosure, the primary focus was the need for disclosure to consumers of the rate of return on the savings element in cash value life insurance. Such disclosure is an essential part of a rigorous system of information disclosure. Most of the industry criticism of this report has been unjustified, poorly conceived and ill-advised. Those are just a few examples of areas of some controversy and where I stand on them.

There are four areas we will discuss today. I had a little difficulty separating these four because, as you will see, they are closely related. The four areas that we identified are: first of all, disclosure to existing policyholders; the second area is the policy loan problem, at which point we will include what is sometimes referred to as the replacement problem; the third area is dividend determination practices; and fourth, deceptive sales practices in the life insurance business. If those four areas are completed very quickly, there are a few others that we might profitably turn to.

MR. HAROLD G. INGRAHAM: I would like to say, first, that the fact that I am sitting to the right of Joe Belth is not entirely accidental. Three people talked to me at the break this morning and said, in essence, "I understand that you are going to take on Joe Belth this afternoon." I do not think "take on" is the right way to put it. One said, "You have a lot of guts"; the other said, "You must be crazy"; a third asked, "Can you ever say no?"

I must say that I am looking forward to interacting with Joe. I guess it is well known from reading Joe's _Forum_ that he does not suffer insurance fools gladly. But much of what he says has considerable merit. Yesterday, at lunch, when we were discussing what we were going to say and when it became clear that everybody in the panel except Joe had to catch a plane right after the panel, Joe volunteered to finish the session by himself, at which time Dan Case developed a tic and turned ashen-faced.

I do applaud the chance for this kind of public interaction with consumerists. By the way, Joe and I are both consumerists in the sense that we both have maximum-loaned our cash value life insurance policies in the interest of college education. My final preliminary comment is in reference to the _Forum_. It is a very interesting publication, and it performs a useful service. One suggestion I have for Joe with respect to that _Forum_ is that perhaps it might be enhanced if actuaries and other people in the insurance industry would be invited to write guest editorials. Other points of view would add more cross-reaching opinions.

MR. J. BRUCE MACDONALD: As Dan has told you, this panel is pretty well unrehearsed - possibly to give a bit of interest to an otherwise dull subject.

My usual reaction to the subject is a "plague on both your houses". Too many consumerists question everything the insurance industry does, and very often for self-serving motives. Further, they show a marked rigidity of mind: having finally understood interest-adjusted net cost, they do not want to admit its deficiencies or learn alternatives. And I often doubt if they are really interested in the consumer, anymore than a member of the Comintern is really interested in the proletariat - they are just interested in their place in the power structure.

I better add that I do not consider Joe Belth a consumerist, although I am sure a lot of you do.

On the other hand, the insurance industry is so conscious of its own moral rectitude, it cannot cope with criticism, especially if it is informed (that is its problem with Joe Belth).

Basically, life insurance is designed to fill a need. If the need is not there, it should not be bought, no matter how "cheap" it may be. The insurance program must be designed by a competent, ethical individual, usually a life insurance agent. The quality and quantity of service is more important than price - and this has to be paid for. This applies to a lot of things besides insurance. We have supermarkets which do not supply bags, and the customers bag and carry out their own groceries. They are definitely cheaper, but many people do not use them. Too often consumerists know the price of everything and the value of nothing.

On the other hand, the insurance sales representatives who attempt to convince the buyer that he is getting something for nothing, or getting a fantastic return on his money, do a disservice to the whole industry. They are hustlers - not professionals - and are even worse than the sellers of flamingo policies (for a premium of $1,000 you get a $10,000,000 death benefit if you are kicked to death by a herd of flamingos while visiting Antarctica). In this case you at least understand what you are not getting! As a result, I have always distrusted elaborate presentations usually involving more figures than I put into a valuation report. They are usually incomprehensible, frequently misleading, and almost invariably irrelevant. If the insurance is needed, the cash values, etc., are a nice bonus - like discovering the cough medicine has a nice taste. And if the insurance is not needed, it should not be bought despite the alluring presentation.

To wind up these opening remarks, the North American life insurance industry has placed itself in a bad position because of the insistence on guaranteed cash values and guaranteed policy loan rates. The first has forced it into an investment strategy that gives little inflation protection, and the second has guaranteed that the investment returns even within the constraints imposed are sub-par. I have just received my municipal tax notice and an insurance premium notice: if I am late on the first I pay 22%, but on the second I only pay 6%. You can guess which I am paying first!

I suspect both practices were forced on the life insurance industry by a previous generation of consumerists, and neither the industry nor the consumerists were bright enough to see the ultimate problems.

Perhaps the best thing for all involved would be for life insurance to adopt cash values that are not guaranteed and depend upon market conditions. In addition, the British bonus system for participating insurance should be reconsidered. Just because we did not invent it, does not mean it is without merit.

Finally, insurance companies should consider doing something for old non-participating policyholders. While this was never anticipated, neither were current economic conditions. If the insurance industry is not prepared to evolve, it must be prepared to emulate the dinosaurs.

MR. BELTH: The first area is disclosure to existing policyholders. I will simply outline a few items which would be very useful if they were disclosed to existing policyholders. I should preface this by saying that I am thinking in terms of an annual report or annual disclosure statement that would be sent out to all existing policyholders. Two critical items of information would be in it. The most critical and perhaps the most controversial would be, first, the price of the protection component of the life insurance policy during the past year. And second, the rate of return on the savings component of the policy during the past year. A couple of other items which are probably less controversial but nevertheless create interesting responses from audiences that hear them would be the amount currently payable on death, if the insured dies, and the amount payable if the policyholder surrenders the policy. Finally, if a policyholder has an existing policy, he should be able to obtain upon request a rather elaborate statement concerning the important elements of the policy looking forward into the future from whatever policy year this happens to be. I am referring to the kind of disclosure that might be routinely available in the sales situation. I am not referring solely to the situation when replacement is suggested although such disclosure would be possible in a replacement situation. I would not even see any harm in the insurance company charging a fee for providing such a statement if such a fee were reasonable and reasonably administered. But the availability question is critical. Those are some of the things that I refer to when I talk about the notion of disclosure to existing policyholders.

MR. INGRAHAM: In any consideration of cost disclosure at point of sale or for existing policies, it is helpful to start not by referring to what the insurance companies might think is appropriate or what a consumerist might think is appropriate but to try to find out what the consumers want or what their perceptions are. In that regard, I will share with you the results of a recently published study of the ACLI and LIMRA, a study that commenced in 1979. It was called "The Consumer Experience in the Marketplace Study", and it surveyed the opinions of insurance buyers and non-buyers with particular emphasis on cost disclosure. The findings of this study were based on over 5,000 responses from people who had talked about insurance with an agent during the past 12 months before they were surveyed. Here is a brief summary of those findings:

1) Two-thirds of the respondents think there are cost differences between companies, but less than 4 in 10 think the cost differences are large;

2) Only 18% of the respondents said they ever compared costs for similar life insurance policies in their most recent encounters with an agent;

3) Another 22% said they did so on some previous occasion which means in total a generous estimate of cost comparison activity in the marketplace might be about 40% according to this recent study.

Now where does this 40% go for the comparison information? Four in ten asked the selling agent, another four in ten asked another agent, and the balance asked friends and relatives.

What methods were used to compare costs? Almost six in ten compared premiums, four in ten compared death benefits after ten or twenty years, and about three in ten examined what they would have paid for the policies if they were to drop them or cash them out in about ten or twenty years. But only 11% said they ever used the cost indexes, so at least based on that survey, the indexes do not appear to play a significant role for even those who do compare costs.

One key revelation of that survey is that some of the NAIC materials are not getting in the hands of consumers, or they are not being remembered. For example, only 8% of all respondents said they ever received a buyer's guide from an agent on their most recent encounter. Another 5% received a booklet on some previous occasion. In the states where the NAIC model regulation is in effect, which are about two-thirds of the states now, 17% recall receiving a buyer's guide at one time or another.

A policy summary had more of an impact. Almost six in ten of the buyers said that they got them. Of those getting the buyer's guide, seven out of ten said they had a favorable impression of it. They said they had a better understanding of life insurance in general. But most recipients either did not read or did not understand the section of the guide that deals with cost indexes. The general response to the policy summary was favorable: 85% said it was helpful in understanding the relative cost of the policy and almost eight in ten said it gave them a better understanding of the policy.

There was a strong correlation between those receiving the NAIC model regulation materials and those having a favorable impression of the agent or the company. Recipients of the buyer's guide were twice as likely to be satisfied with the information they got from the agent versus those who did not get any buyer's guide. The figures were 62% in the first case to 31% in the second. Willingness to buy again from the same agent or company is also highly correlated to getting the buyer's guide and policy summary. Of those getting the buyer's guide, three in four said they would buy again from the same agent, but less than half of those not getting the buyer's guide said they would do so.

The other comment I want to make has to do with post-sale disclosure as it relates to Universal Life. With these types of products, you have the classic problem of trying to provide the consumer with all the needed disclosure information while at the same time trying to minimize the cost to the industry and ultimately the consumer by not providing unnecessarily excessive information. Here the two basic areas of concern are: (1) how these products can be presented to comply with the existing regulations such as solicitation and replacement regulations, and (2) what continuing disclosures to the consumer are probably needed due to the product's flexibility characteristics. With respect to compliance with existing regulations, in the preparation of any indexes or illustration, it is necessary to assume some pattern of future premium payments. Since the consumer is free to vary the pattern, the subsequent actual results almost always will differ from those originally presented. There are two alternative illustrations after first making the premium payment assumption. The first is to use the guaranteed interest rates and mortality charges, and the second is to use current rates and charges with an appropriate disclaimer that they are not guaranteed. As long as the consumer is provided with both sets of values, the existing regulations should be reasonably well satisfied.

The New York Insurance Department has suggested the possibility of an actuarial certificate as to the reasonableness of the underlying assumptions and sanctions against the use of what they would deem unreasonable assumptions.

As to continued disclosure, the very nature of Universal Life makes it difficult, if not impossible, to provide a table of values for the policy which is meaningful. The same flexibility which was originally so attractive could subsequently cause confusion because the consumer is unable to determine present values by reference to the policy. So, there is the risk of policyholders quickly losing understanding of the long-range funding options. Consumers need access to updated information. Some of the companies marketing Universal Life plan to provide new illustrations upon request, in addition to an annual statement showing current cash values, premium payments made, outstanding policy loans, current death benefits and current interest rates being credited.

One company newly marketing this product plans to send to its policyholders, at least once a year, a statement of account that shows all transactions for the last policy year. Premium payments as well as the cost of pure insurance and the interest credited will be reflected along with the cash paid balance. This statement of account will also contain the so-called "message board" which will announce any new options.

Access to updated information should adequately take the place of information which cannot be a permanent part of the policy. With continual updating of information, including actual results, the policyholder then will be better able to make an informed decision on whether to increase premium payments, maintain current status, or even increase coverage without any additional outlay of premium payments which he can do under Universal Life, provided the cumulative cash value is large enough.

MR. MACDONALD: It is very difficult to be opposed to disclosure in principle. It is like being opposed to motherhood, but then again, there are people in favor of birth control. What always bothers me about disclosure is that if it becomes mandatory and it becomes too complicated, I can envision the day when it will cost more to put in disclosure materials than it will to pay the death benefits. But I do like the idea of annual statements, certainly those indicating what the death benefit is. Some insurance companies presently allow you to figure this out. They tell you the loan value even if they rarely tell you the cash value. You are supposed to be able to look it up in the policy.

By and large, in Canada, legislation on what insurance companies should do in life insurance is not that different from what is being mandated for pension plans; that is, some information has to be furnished to members; some mandatory, some on request. Perhaps this is more necessary on pension plans, because from reading the plan document you certainly cannot figure out what pension you have earned to date, although that might be possible with a life insurance contract. I do not know what pension plan members and insurance policyholders will do with this information, but it is information they should have and it probably should be furnished to them - unless it is from a certain insurance company which always sends information saying that "this information has been prepared by our records and has been checked carefully but we do not guarantee it is correct."

MR. BELTH: I would just like to make one comment on the ACLI and LIMRA study which I just heard about a little while ago. What strikes me is that asking consumers of insurance about their reactions to some of these things cannot lead to anything but rather erroneous public policy. In the first place, consumers of life insurance are probably generally more ignorant about life insurance than almost any other consumer product. To ask people who are totally ignorant about what information they would like to have or what kind of response they have to certain proposals, is not a fruitful way to proceed. Furthermore, focusing on consumers' reactions implies that the only real purpose of disclosure is consumer information. I would like to express the opinion that the purposes of disclosure are much broader than that. Maybe we can categorize the purposes in this fashion. Certainly consumer information is one of them--to provide the consumer with information so he knows what is going on and can make appropriate decisions in his own interest. The second purpose of disclosure in life insurance, certainly, is information for agents. I happen to believe that the agent performs certain very crucial functions in life insurance and that it is extremely important for the agent to be informed, so he can better act in the interests of his clients. Thirdly, a very important function of disclosure is for the benefit of insurance company officials. In the absence of rigorous disclosure, many insurance company officials will be in the dark about where their insurance stands relative to insurance issued by other companies. Insurance company officials can make great use of information made public through rigorous disclosure requirements. I said it more bluntly in the concluding chapter of my consumers handbook which was published a few years ago. I refer to the life insurance market as being characterized by ignorance, complexity and apathy. When you have all three at the same time, you have serious problems. I then went on to point out that by ignorance, I meant consumer ignorance, agent ignorance and company ignorance. I was not confining myself just to consumers. When we discuss what information should be provided we should be thinking not only in terms of what affect the information might have on the consumer, but also what affect it might have on agents and companies. There are certain things going on in the marketplace today that would not go on if there were rigorous disclosure, even if no consumers ever looked at the information, let alone understood it. Disclosure would have a very powerful affect on what company officials decided to do.

MR. INGRAHAM: Joe, a lot of what you say is still true. It was a lot more true ten years ago, and I suspect it will be a lot less true five or ten years from now. Because of the pronounced acceleration of the winds of change in the industry and corresponding changes in the product mix, the dramatic evolution of dynamic products and the replacement of old products, companies--like it or not--have been dragged kicking and screaming into the 1980's. A lot of products which were probably missold or overpriced or never fully disclosed regarding cost implications are now bearing the full weight of rigorous scrutiny. One point that has not been made is what agents do when they have established a sale. Do they mention the comparative merits or non-merits of one product versus somebody else's product? One area where agents have been guilty in the past is selling the wrong product to a customer. Sometimes the agent is motivated by the larger commission. If you accept that agents honestly and fairly present a product which is really the right kind for the customer, for example, term versus permanent, the next issue is how he should compare company products if they are similar. I have always taken the approach that some kind of reasonable ranking mechanism be used. The Interest-Adjusted Cost Method with all its faults still correlates in company cost rankings with other methods like the Linton Yield method and the incredibily bizarre index that was produced by the NAIC last fall.

The other thing I want to say in this regard is that if you sell to sophisticated corporate markets, as my company does, single indexes do not mean very much. Those people want to see ledger sheets; they want to know where their money goes year by year. This means more to the average insurance purchaser than some inexplicable index, regardless of the assumptions underlying the index. As far as disclosure after the point of sale for highly flexible products like Universal Life, it is terribly important that there be some method of annual statement of value periodically updated with danger signals; such as, unless more money is put in, coverage will expire on a specified date in the future. That is important notification.

But, insurance regulators and consumerists go off the track when they want to drown the consumer with excessive information. Then it becomes counterproductive because the consumer will not look at it at all. It becomes the same as junk mail. One of the reasons Northwestern Mutual does not have a higher acceptance rate on their update program is because some people consider it junk mail and do not even read it. If they did, they would learn that they could have 15-20% more coverage without any additional outlay of money. For disclosure after the point of sale, you have to be extremely careful that you do not inundate the customer with information because he will not read it at all.

MR. MACDONALD: There is not very much to add to what has been said. Joe made a good point: if this information is available, it will allow agents to do a better job even if the policyholder does not understand it, and I am convinced that he will not. I am very sympathetic with what Harold had to say about drowning them in figures. We all get inundated with figures and pay no attention to them. By disclosing too much you effectively end up disclosing nothing. Like a girl in a bikini, what is disclosed is interesting, but what is concealed is vital. When we have all this information, it will be great fun finding out what really has been concealed.

MR. BELTH: The second topic is the policy loan problem. I would like to distinguish between the problem associated with the sale of new policies and the problem with existing policies. On new policies, a variable policy loan interest rate is essential. I have been suggesting this for a long time in private conversations, although I must confess I have never recommended this in print. There should be a variable policy loan interest rate not tied to any kind of index. I do not advocate any kind of index whether it be a Moody's Bond Index or any other. It would be reasonable to have the policy loan interest rate determined by the board of directors from year to year or time to time, or something similar to what is already in the policy on settlement option interest rates. However, in addition to complete flexibility on the policy loan interest rate, I think there should be certain disclosure. The annual disclosure statement mentioned previously should include an indication of the policy loan interest rate that would be in effect for the next year or so. That information should be disclosed not only to people who already have policy loans but even to people who do not have policy loans. If it is not going to be fixed and specified in the policy, then it seems to me the obvious alternative would be to spell it out at least once a year.

On existing policies, the problem is more dramatic. I would like to mention a few alternatives, a couple of which I am sure you have heard of; some you may find a little different. First of all, there is what Northwestern Mutual did in 1976 with their policy loan interest rate amendment program, not to be confused with what they did in 1980, called Project Update. In 1976, they offered their policyholders who had 5-6% policy loan interest policies an opportunity to have their policies amended, to have an 8% clause in exchange for being placed in the 8% class for dividend purposes. At the time I expressed serious reservations about this program; I have not changed my mind. But this certainly is one approach to solving the problem of fixed policy loan interest rates during a time of rapidly escalating market interest rates.

The second approach is sometimes called "direct recognition". The phrase "direct recognition" means the recognition in the dividend formula of a single policyholder's policy so that his dividend would directly reflect that single policyholder's policy loan activity. That means if you had two identically situated policyholders who had historically always received exactly the same dividend, and if they engaged in different policy loan activity during the same year, their dividends at the end of that year would differ. The subject of direct recognition has been of great interest to a number of people. I was rather startled a few months ago to learn that a major company had actually gone to direct recognition, and I wrote an article about it in the February issue of the Insurance Forum. The February issue discussed Franklin Life's dividend enhancement program which is a major step in the direction of direct recognition. I am not sure it is precisely what the writers on the subject would regard as total or pure direct recognition, but it certainly is a major step in that direction. I think direct recognition results in an improvement in equity in the dividend formula. But I feel just as strongly that it also violates the policy loan clause. Of course, what I feel does not carry any particular weight. What matters is what the courts decide about whether the notion of direct recognition constitutes a violation of the policy loan clause or not. Eventually, that matter will have to be litigated.

A third approach would be some kind of government fiat. The question is this: Is it possible that the problems of policy loans will become so important for the survival of the life insurance industry that it would justify a blanket unilateral change in existing contracts, and if so, could such a change be carried out through some kind of governmental or judicial fiat? I am just raising that as a question.

The fourth possibility is what I would like to label the concept of the portfolio rewrite. I am referring here to something beyond what Northwestern did in 1980 with Project Update or even the combination of Project Update and the loan interest rate amendment program. I am referring to a complete rewrite of a company's block of existing business. I do not want to use the word replacement because of its pejorative connotations. I would rather use the word rewrite because policyholders would be given or perhaps offered brand new style policies with all the characteristics of new policies including more favorable price structures, different settlement options, a variable policy loan interest rate provision, etc. The policies would be written as of the original issue date so they would not really be replacements. They would be rewrites of entire portfolios. I am a little frightened about this particular suggestion because it is my suspicion that many companies have not been treating long-time policyholders in a reasonable fashion. A complete rewrite would be an enormously expensive proposition, not only in mechanics but also on how it would affect the future price structure of rewritten policies compared to policies that had not been rewritten.

MR. INGRAHAM: I would like to comment on distinguishing or not distinguishing in the dividend for individuals who borrow or do not borrow. A good jumping off point is considering the issue in the Greeff vs. Equitable case of 1899 which established the discretion of boards of directors to determine dividends. Since then, courts have made it consistently clear that a mutual company acting through its board has broad discretion with respect to both the determination of the amount of divisible surplus to be distributed in any year as dividends, and also the method of the apportionment among policyholders. For as that Greeff case said, "The statute leaves discretion to each company as to what constitutes an equitable apportionment, and when the directors have exercised their discretion in regard thereto, the courts will not interfere unless there is bad faith or willful neglect or abuse of such discretion." That leads into the question of whether or not borrowers and non-borrowers are to be placed in separate dividend classes for dividend apportionment purposes. That is a moot question and has not been litigated. But there is some interesting case law in several states holding in effect that there could be no discrimination between borrowers and non-borrowers with respect to the availability of nonforfeiture options. Let me read from one interesting case, Trapp vs. Metropolitan in the 8th Circuit Court in Missouri in 1934. It reads, "The purpose of the anti-discrimination statute is to secure to the purchasers of life insurance of the same age and condition of health, equality of treatment with respect to premiums and coverage, to prevent rebates from being given and favoritism being shown, and generally to secure to those who buy insurance the coverage which the premiums actually paid entitle them to receive. Such statutes are not intended to prohibit the companies from writing policies which contain inducements to all policyholders alike to refrain from borrowing upon their policies or which make some uniform distinction otherwise lawful between those who borrow and those who do not."

One more comment on the subject of the Franklin Life's dividend enhancement program. For over 20 years a company has been varying excess interest or experience refunds to pension trust policyholders on the basis of whether the loan privilege in the policy was utilized or not. Until February of 1980, they did not have a par line. Then, the company began to issue par policies with a true dividend clause rather than just referring to excess interest. When they filed the policy, they put a notice in both the loan and dividend clauses that the use of the loan privilege might generate a difference in dividends payable to policyholders. They also included notice of that in their dividend illustrations. This company is not admitted in New York, but they did obtain approval from 37 states including New Jersey. They took the notice out of their policy forms because their home state would not approve it. However, according to an actuary at the company, their home state would allow them to do it as long as the fact was not included in the policy. Once the fact was stated in policy form, it gave the appearance of the state formally blessing the practice. In other words, the home state insurance department took the exact opposite approach of consumer disclosure by telling this company they could proceed only if they did not notify the policyholder in the contract.

With respect to update offers, Northwestern did two things. First, they allowed policyholders to upgrade their policies by going to a higher policy loan interest rate with a better dividend scale as their reward. Next, and separately, they introduced Project Update in which policyholders went to a higher reserve interest basis and got more insurance for the same outlay of money. These are two different programs. The policyholder can receive the second without the first. My company is going to do it differently. Our project update-type offer makes it a condition precedent to the offer that a policyholder change the policy loan interest rate from a lower rate to a higher rate. We expect a lower acceptance ratio, around 40 to 50%. Those who move clearly will be in a different and superior dividend class. That raises questions about those who do not make the change because those policyholders represent a higher concentration of borrowers. Is this changing the composition of the class after establishing the class in the first place? Is it feasible to continue a dividend scale when this means subsidizing a scale for a long time? Or if you do not continue a scale, do you peg the scale or let the dividends "free float" according to the experience factors applicable to the new class? Either way, you are open to criticism, not to mention being involved in serious questions of equity.

Also, regarding Joe's comment that many companies have been ripping off old policyholders at the expense of new policyholders, I believe that the opposite is more often true. In many cases, companies are subsidizing old policyholders, such as using a pure portfolio approach to investment determination in the dividend formula. Also, in situations of changing the class, companies will bend over backwards to prop up an old dividend scale because of what is called the implied contract theory.

MR. MACDONALD: Nobody has mentioned the problems of non-participating policies. Can it be that everybody is happy with what is happening with our non-par policies, and the insurance companies are delighted with their 6% loan rates? Manu-Life is doing something with respect to all non-par policyholders.

I have been worried for a long time about the problems caused by maximum interest rates, although I suspect they were caused by actuaries not making very good predictions on where interest rates were going. They guaranteed to lend money at a maximum rate so high we never expected to see those rates paid again. That was back in the days when I began my actuarial training, and I was told we would never see a 4% rate in government bonds again.

At that time, it was impressed upon me to maintain equity and treat everybody fairly. As far as I know, we did a pretty good job. What bothers me now is when we divide par policyholders into different classes of people, some of them will not participate in the profits from a certain class of business. I understand the arguments supporting this, but nobody ever told an individual when he bought his contract that his profits might be linked to a rather small class of business that might ultimately be unprofitable. On the other hand, I have the same opposition to switching from the pure portfolio approach to the investment year method. A policyholder once told me that he did not really care which method we use as long as we did not change the method on him, and that he was convinced he would get a fair shake as long as we were consistent.

MR. BELTH: It is feasible for a block of non-participating policyholders to be offered a policy which, in addition to other things, would also contain provisions for future dividends. Some people believe that non-participating cash value life insurance is simply inappropriate under current economic conditions. If that is the case, then certainly the rewrite would involve a shift of a block from non-participating to participating.

MR. MACDONALD: At a former company, we had one old line of business in which we provided that any policy became participating after 20 years whether it was participating or not in the first place. We discontinued that in the early 1930's because it was old fashioned. Its time may have come again.

MR. BELTH: It may have. There are also policies around which are participating, for example, for the first 20 years during the premium paying period and then become non-participating. And there are those that are participating throughout, and then they simply stop paying dividends after 20 years on the grounds that if there are no premiums, there is no reason to pay dividends.

MR. MACDONALD: That is absolutely logical. A dividend is a refund of the overcharges, and if they are not charging anything, there is no overcharge to refund.

MR. BELTH: Just one comment on dividend determination practices. Despite what Harold says, a number of companies are paying inadequate dividends to long-time policyholders, and for that reason I have watched with considerable admiration and frustration as committees of the Society and the Academy have wrestled with some difficult, delicate and controversial problems in this area. I was favorably impressed early in the deliberations when the principle of disclosure was enunciated as the basic approach to be followed. As I recall, there was concern that equity is very elusive (and I have to agree with that) and that almost anything can be justified. Maybe we should disclose what is being done and then let the person who has developed a certain dividend formula defend what is going on and base the whole thing on the principle of disclosure.

But now I find that the so-called disclosure, or at least a large portion of it, is to be contained in an actuary's report submitted on a confidential basis to company management. I ask my fellow panelists if they feel that the preparation of a secret report to management is consistent with the principle of disclosure.

MR. INGRAHAM: Joe, that is not my impression. The report will go to management for the basis of management's determination of dividend apportionment for the next calendar year. Personally, I do believe there will be a requirement at some point that these reports also go to the company's home state insurance commissioner. If I am correct, zealous consumerists will have to deal with the home state insurance commissioner to get their hands on these reports.

MR. MACDONALD: We have pension legislation in Canada now that insists an abridged valuation report be made available to anybody who wants to see it, or in other cases, information is available through negotiations. I do not understand why an important insurance document cannot be given to mutual company policyholders. But we will have to amend the document if it is going to get wide circulation. An author of a report bears his audience in mind. If he knows that the report is going only to management, he can be much more critical of company practices than if it is going to, say, a labor union.

MR. INGRAHAM: Joe has been concerned about the validity and comparability of dividend illustrations because different companies have different methods of determining their dividend interest rates. I agree that there cannot be full comparability as long as some firms use one method and some use another. Some companies take all their selection costs and excess first year expenses and distribute them over all policies on the premise that the continued vitality of the company demands additional investment in new business. On the other hand, other companies take such expenses and charge them only to that specific block.

That leads to the topic of performance dividends. There is a mutual company with stock subsidiaries that declares and pays each year a performance dividend based on the earnings of those stock subsidiaries. That is how the company justifies its investment in downstream companies. Now, how do you illustrate projected dividends for them? Do you assume the downstream subsidiaries will have a certain level of earnings? Do you project on the basis of the last year or two of experience? And how do you get comparability? Those problems of comparability make the question of comparability between the investment generation method and the portfolio method seem downright trivial.

Regarding the implied contract theory, there are several situations that can be troublesome. The first is when you change your method of amortizing initial expenses. A second is what to do when you have non-smoker price distinction for new policies, but the old policies blend smokers and non-smokers together. This relates to the policy loan issue referred to earlier. At the time a policy was issued, there was a certain practice of combining or separating policyholders. Is that an implied contract or not? If you give older non-smokers in a closed block of policies an option to receive a better price, you have changed the composition of that class. Are you being fair with the other policyholders who may have bought the contract on the assumption that the experience would be blended? Are you being fair with the old policyholders who thought expenses would be amortized in a certain way or that investment earnings would be credited in a certain way? Are you treating everybody equitably if you redefine the policy class years after the class was established?

MR. BELTH: There are major problems involving the lack of comparability of dividend illustrations. I do not have a solution except to say that this lack of comparability is one of the reasons why annual disclosure to policyholders after the sale is an absolutely essential part of a rigorous system of disclosure. Most of this discussion has been about point-of-sale disclosure and very little devoted to post-sale disclosure. As long as there is post-sale disclosure, I think there will be some restraint on what is done for sales purposes, at least I would like to believe that.

I have a very simple response to the implied contract question. In the March, 1979 issue of the academic journal, The Journal of Risk and Insurance, I wrote a full-length article dealing with surplus distribution problems regarding post-sale classifications. The article discussed about a half-dozen different types of post-sale classification schemes, one of which was shift to the investment year method. Another scheme was shifting to banding of the expense component of the dividend formula after the company went to premium banding. I feel that all of these are a breach of an implied contract. I disagree with what I call the infamous Rhine vs. New York Life case, and I vehemently support the minority view of the court.

MR. MACDONALD: By and large, I subscribe to the implied contract theory. It is changing the rules of the game after it has been started. There might be cases where it is legitimate. But the idea of reclassification post-sale bothers me a great deal.

MR. BELTH: The final area is the subject of deceptive sales practices. About 10 years ago, I included in some Congressional testimony a technique employed by a top agent of a major company. When I sent my testimony to the chief actuary of the company, he telephoned to say, "Joe, I am sorry that you sent this to me because now I have to do something about it." That comment stayed in my mind all this time. Recently, I conducted a survey among 50 Fellows of the Society, one in each of 50 companies. The results are discussed in the June issue of the Insurance Forum. The basic question in the survey concerned the professional responsibility of an actuary who becomes aware of the possibility that agents of his company are using improper sales material. I received exactly 25 responses out of the 50, and 23 of the 25 stated that they thought the matter called for positive action. Two of the 25 said they could not answer the question without seeing the sales material. Three weeks ago I sent out a follow-up survey in which I was highly specific about the sales material. I apologize that I do not have the results of this follow-up survey for this meeting.

MR. INGRAHAM: I do have something to say on this topic. We might make up bumper stickers for the marketing people which say, "Stamp out deceptive sales practices."

Mr. MACDONALD: My answer would have been with the vast majority of actuaries who, if an agent was doing something wrong, would take action.

MR. WALTER N. MILLER: If anybody in the audience came here expecting a bristling confrontation, they are sorely disappointed, and I would like to congratulate the panel for sorely disappointing them. I found this to be a most interesting and rewarding session. I would like to make one comment on behalf of the Academy of Actuaries' Committee on Dividend Principles and Practices, of which I am a member. Joe mentioned his unhappiness with most of the information ending up in what he described as a secret report which may never see the light of day. Harold made a brief mention of the fact that the Academy has proposed some rather far-reaching changes in Schedule M disclosure. I would just like to take a minute to discuss the breadth and scope of these changes. We are talking about exhibits B and C of the exposure draft report of this Academy committee which were originally circulated last fall. These were the committee's proposals for revised Schedule M disclosure and for changes in disclosure in sales illustration materials and buyers' guides. A redraft of these exhibits B and C by that committee will be available shortly. The revised Schedule M disclosure adds a considerable amount to the original exhibits. It provides for disclosure in Schedule M of every material deviation from the standards of proper actuarial principles and practices of dividend determination as adopted by the Academy. It provides for disclosure of specific information about investment year vs. portfolio method, the way that investment years are blocked off if such a method is used, treatment of policy loans in dividend scales, indications as to when dividend scales for major blocks of business were last changed, and the amounts by which they were changed, and other information. It goes on to suggest disclosure of the most important of those items in sales illustrations, including some of the deviations from principles and practices if the actuary certifies they have occurred, statements as to investment year vs. portfolio approach, etc.

We believe quite strongly that we have a proposal for a system that is really in line with what Joe has suggested; i.e., it is relevant, responsible disclosure that is much further advanced than secret reports.

MR. INGRAHAM: I would just like to echo what Walt said and direct two more points to Joe. On these guidelines and the reported principles and practices of dividend determination, there is nothing that prohibits companies from adopting tougher internal standards if they want. The other point is these guidelines are not intended to necessarily prohibit any practices, but rather to require disclosure to company management. The guidelines attempt to provide a general family of methods that are equitable and include enough disclosure so that management and the general public can learn more about what the actuary does, and perhaps better cope with changing standards of what might be equitable.

MR. JOHN KROEKER: Any information provided to the general public should be kept very simple. Anything that goes beyond one page might be useful for the agent but is useless to the general public. Someone mentioned that there were three items with regard to sales - ignorance, complexity and apathy. I would like to add one more, exploitation. There are many conscientious, well-informed, reasonable sales people out there, just as there are many conscientious, well informed, reasonable actuaries. But, unfortunately, there are exceptions in both groups.

MR. JOHN O. MONTGOMERY: I have three points I want to bring out. First, the NAIC, at the San Francisco meeting of the Blanks Committee, talked about putting in a schedule comparable to Schedule M for indeterminate-premium plans to show the maximum premium payable on these plans and a history of the premiums that have actually been charged. This is still in the drafting form, but it is highly possible it will be included in the new simplified blank. That will not make it more simple. The second point is that in our meeting on Universal Life in Los Angeles, we obtained material on annual disclosure, and it falls in line with what Joe said. All the people we know who are writing Universal Life have annual disclosure of the items mentioned, plus all expenses of the policy. The next and last point concerns rewrites, which Joe already mentioned. This is extremely important with the advent of the new dynamic valuation and non-forfeiture laws. It seems that there will be considerable pressure during the 1980's to rewrite and reissue business written on obsolete forms. By obsolete I mean when companies are no longer providing the same benefits and coverages under current forms of policies. For that reason, companies should disclose on an annual basis the policies they have and protect themselves by offering to rewrite some of these policies in some form.

MR. BELTH: I was hoping that someone, either on the panel or in the audience would comment on the notion of government or judicial fiat as a method of unilaterally changing existing contracts.

MR. MACDONALD: I have a profound distrust of unilateral government action. One of the things that amazes me is the implicit faith that the labor movement has in the government's ability to take over everything and cure all problems.

MR. JOHN K. BOOTH: This is purely from memory, but I believe that back in the early days of the group annuity industry in the early 1920's, there were a few companies which wrote group annuities with perpetual rate guarantees such that, as long as the group contract remained in force, there was a guaranteed annuity purchase rate for anyone who might retire. When interest rates began to decline and people started living longer, some of these contracts wound up in serious shape. At a former company, we did periodic studies to determine whether we should try to go to court to see if we could avoid carrying out terms of that perpetual contract. To my knowledge, that company never did. I think there was a company that did take a case to court, and the court found the guarantees went so far beyond reason, considering subsequent developments, that the company did not have to live up to the original terms of the contract. However, I think the company that went to court did suffer some adverse publicity.

MR. BELTH: Before you sit down, John, let me ask you a question. Rumor has it that there were some extensive discussions between highly placed life insurance officials and officials of the Federal Reserve in April, 1980. Would you care to discuss exactly what the nature of those conversations was?

MR. BOOTH: I was not present. There were some discussions; as you know, in the Spring there was a policy loan crunch. There have been discussions held periodically as far back as 15 to 20 years.

MR. BELTH: I raise the question whether the disintermediation problem could conceivably become so serious as to threaten the viability of the life insurance industry and force some kind of unilateral governmental action in order to save, or literally bail out, the industry. One incident that I recall which somehow has been blacked out of most textbooks was when the NAIC (it was then the NCIC) allowed life insurance companies to change their valuation rules for just one year. Was it 1932?

The life insurance industry takes great pride in its survival of the depression, although it seems to me that it was bailed out by government intervention. I wonder if the time may come again, say if the prime rate goes to 38%, that the life insurance industry will need to be bailed out in some fashion. I do not know what that fashion might be, but that is why I am curious about the nature of the discussions of April, 1980.

MR. BOOTH: We have a committee within the ACLI that has been looking into the whole liquidity question, and on the basis of those discussions, I believe there is much more liquidity in the industry today. If I recall correctly, the biggest surprise came about 15 years ago, when the first discussions were held with the Federal Reserve because of the first policy loan crunch. That was the real shock, because it had never happened before in the industry. This is the fourth wave now, and I believe the industry is used to it and is getting its portfolios in order to meet these demands when they come.

MR. INGRAHAM: If the kind of hyper-inflation that Joe is talking about does develop, the industry will be in very deep trouble and will need some kind of government bail-out. But assuming it does not reach 38%, even with periodic spikes in interest rates from their present levels, companies are concerned because increased cash withdrawals decrease new money inflow and reduce payback of existing loans. High interest rates mean more negative cash flow, so companies are changing their investment postures. They are using investment managment philosophies like those of commercial banks, trying to align assets and liabilities. Because they are trying to assure current yields and rates of return that reflect market conditions, they are going to "spread management", where the goal is to assure that the spread between asset yield and liabilities remains positive. This means setting interest rates on new commitments at time of take-down, more liquidity, bonds with shorter maturities, and rates that are renegotiable every five years or so. It means warrants on conversion features on bonds and income participation on mortgages. This relates to Joe's perception of company practices in determining dividend interest, new money vs. portfolio. My overriding thesis is that no matter whether it is Northwestern Mutual, Equitable, or anyone else, it will all become moot if these changes take place in the investment mix of companies because everybody will be, de facto, on a new money basis by the end of the 1980's. There will be a pronounced convergence of the new money and portfolio approaches because of the change in the investment mixes of companies going short on liabilities. And it will be all the more so for heavily loaned blocks of business.

MR. WALTER W. STEFFEN: Regarding the subject of a government fiat, in an isolated case in the state of Indiana within the last 10 years, a commissioner did cancel a company's benefits for certain coverages. Certainly, it would be possible to do the same thing for another company or for the entire industry by that type of regulation or fiat.

MR. BELTH: That was an action taken by a commissioner, but it was a rehabilitation program which was fought over for almost three years, and finally judicially approved.