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PROGRAMS TO CONSERVE TRADITIONAL LIFE INSURANCE POLICIES

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1. Efforts to combat replacement of inforce traditional life policies

2. Dividend illustrations on inforce policies

3. Programs to increase life insurance amount on inforce policies

4. Amendment offer to existing business to obtain market interest rate for policy loans and, as a result, obtain better net costs

5. Field compensation based on renewal persistency results

MR. PETER J. BONDY: Some of the attractions of the Magic Kingdom remind me of aspects relating to our subject today.

The first is the Haunted House and its dancing ghosts which appear to be real and not real, depending on your angle of view. This reminds me of the distinction between a true lapse and a replacement. When should a lapse be counted as a replacement? What statistics should be kept to differentiate between the two? How many companies are truly keeping appropriate statistics? Also, what about policy loan situations; aren't these built-in lapses or, possibly, replacements? Have we started to take these into the proper perspective?

As you will note from the comments which our speakers will make, we need to hone in and better define and measure these items.

Having dealt with the previous ones we come to the general issue of conservation. We can define conservation as the process by which we maintain for our company, business which was previously obtained. On this count, do we take Mr. Toad's Wild Ride and drive haphazardly making quick cosmetic turns before the approaching obstacle; or, do we properly plan our move and follow a smooth course into Tomorrowland? The two mean different things, the first means an attempt to preserve what we had in the past making only bandaid changes, and the second means that we move directly to an entirely new system.

MR. PAUL A. CAMPBELL: In defining the replacement problem, it is important to acknowledge recent deteriorating trends in overall persistency -- short term and long term -- and to recognize the difficulties of distinguishing between replacement and traditional lapse patterns when evaluating those trends.

LIMRA monitors rates of lapsation of business in its first 13 months, on a semiannual basis. We also publish periodic studies relating the two year persistency of a block of business to buyer, agent, and product characteristics. Until recently, we conducted an annual Long-Term Lapse Study, based

on the data of 25 companies. These studies show deteriorating persistency since 1978, with the adverse trend observable in virtually all cells by product and duration, and they probably have not yet demonstrated the impact on longer term persistency of the recent shift in mix of business toward term coverage.

It is conceptually difficult to sort out a "replacement" from other lapsing business, when trying to define the problem and estimate its magnitude. Often company records and reporting procedures do not permit the separation of replacement business from other lapses, so they can either indicate no replacement activity or understate its size.

LIMRA recently conducted a survey of compensation for intercompany replacements, which I will discuss in a few minutes. As a part of that survey, companies were asked to provide a quantitative assessment of their internal replacement activity for the years 1979 and 1980, as well as the first six months of 1981. Only 16 of the 133 participants were able to provide usable data, and only six of those companies gave full statistics for the three year period. A conclusion is that company concern with replacements has not led to a factual assessment of the situation. As a matter of fact, some companies reported replacement as accounting for less than 10 percent of lapses.

Other informal surveys conducted by our Research Information Division indicate that companies believe that 40 to 50 percent of lapses are due to replacement (inter- and intra-company), and that one-half of them are carried out with an agent's initiative.

It is important to recognize that there are some unique causes, preventions, and solutions for replacement -- as opposed to other types of lapsation -- and we will attempt to identify them. On the other hand, replacement can also be seen as part of a larger persistency problem, and we will also dwell on some approaches to improving overall persistency as an implicit solution to replacements.

In an attempt to better define what portion of lapsing policies are due to replacement, LIMRA conducted a survey of 100,000 households, studying responses of 2,400 households where lapsation, with or without replacement, had occurred. Dr. Kent Jamison's analysis is not yet completed, but here are a few general observations, as reported this Spring in the Million Dollar Round Table Quarterly Magazine:

- 48 percent of the households "lapsed only", 36 percent lapsed and replaced, and 16 percent lapsed and intend to replace.
- Higher replacement activity is being experienced in durations 3-10, among larger policy amounts, with term coverage, and with young, upwardly-mobile households, where more insurance was <u>needed</u>.
- Reasons for lapse with replacement are primarily: change in status, such as marriage, birth, transfer, purchase of house; in contrast, reasons for lapse without replacement seemed primarily related to feelings that the policy had served its purpose or was no longer necessary, while those who lapsed and <u>intend</u> to replace cite economic stress.
- 55 percent of replacements resulted in increases in coverage, for an

average increase of $45,000. There was not, however, a massive shift to term coverage.

- Only 29 percent of replacements were recommended by an agent, 18 percent were affected without an agent involved at all.

These findings, and our general perceptions about replacement lead to the following list of causes, many of which suggest a strategic approach to the situation rather than a haphazard, tactical approach:

<u>Causes for Replacement</u>

1. Desire for more coverage, often associated with an update review
2. Economic pressures
3. Availability of better features, coverage, return or price
4. Environmental forces -- interest yields and media pressures
5. Pressure from agents, those merely trying to survive as well as replacement artists
6. Related to #5, an unacceptable degree of quality in the sale

(These causes lead me to ask, are nontraditional products going to be immune from some of the above pressures? I think the answer is no.)

It is important to develop and utilize strategic management principles in dealing with the replacement -- and the broader persistency -- problem. A supporting hypothesis, emerging from LIMRA's many studies, is that replacement is not necessarily a bad phenomena, even though the results may be not as attractive financially to insurance companies.

Our household study has shown us that we can anticipate replacement-prone situations, avoid the creation of some, and minimize others through development of acceptable marketing strategies and tactics. This will be more productive of long-term financial results than defensive holding actions.

Accordingly, it is necessary to articulate a philosophical mission and set broad goals, based upon keen awareness of your operating environment -- particularly competition -- historical performance, strengths and weaknesses, and opportunities emerging from them. Out of this awareness we are able to develop fundamental strategies for markets, channels of distribution and products. Tactics are created to support those strategies, giving your company a long-term perspective instead of short-term reactions.

Now, within this strategic management framework, it is possible to identify strategies and tactics that will either minimize the risk of replacement (and lapsation in general) or acknowledge certain instances where replacement would be acceptable or encouraged.

The first strategic direction to be determined is market emphasis. Using LIMRA's replacement study as a guide, one suggestion could be to <u>avoid</u>

certain replacement-prone marketplaces. Another would be to focus in on existing policyholders (duration 3 to 10) as a resale marketplace. Other market strategies could include lower-income markets, specialty markets, and the salary allotment market.

Another strategic approach in the market sector, prompted by LIMRA's household replacement study, might be to develop an orientation to clients instead of to policies, sometimes conserving clients by replacing policies.

Distribution channel strategies aimed at improving the replacement situation might include emphasis on the career agency system, mass marketing programs, and direct mail approaches to existing policyholders. Another strategic program that would probably counter replacement through more "suitable" sales would be the use of general agency agreements with other companies, using your company's distribution channel as a master broker. A number of companies have done this, including Lincoln National, Connecticut General, Connecticut Mutual, and Mutual of Canada.

The most obvious product strategy to minimize replacement is the development of innovative product groups, based upon the needs of your chosen market sector and the primary distribution channel. Major strategic groups include complex variations of traditional products -- such as adjustable life and indeterminate premium policies -- as well as nontraditional forms such as universal life. Other strategies might include products to meet specialty needs, salary allotment, emphasis on service, and full financial services.

LIMRA's review of the potential for full financial services suggests these findings:

- The public is primarily interested in financial security and generally risk aversive.
- They are, in general, not very knowledgeable about financial matters, products or services.
- Accordingly, they desire financial services and products, but because of the difficulty and cost of assessing and understanding them, most shortcut the process, focusing on what can be called "brand loyalty". (This "brand loyalty" might be a deterrent to certain replacement tendencies.)

This leads us into the financial strategies area, where such directions as different pricing or profit objectives might be considered, along with mergers, acquisitions, and joint ventures. But a major strategy for our discussion today is to improve benefits for existing policyowners.

Programs to increase life insurance amounts in force for existing policyholders have been adopted by 5 companies. They involve an increase of insurance amounts in force, without a corresponding increase in premium made possible by a combination of higher interest rates and tax laws that allow companies to pass those earnings on in the form of adjusted reserves and cash values.

The reasons to entertain these programs include:

- Replacement threat

- Tax relief to insurers
- Marketing impact and public retention -- it is better for the policyowner

The reasons for being cautious about these update programs are:

- Skepticism and possible negative reaction
- Administrative costs and time requirements
- Individual concerns about dividends
- Possible negative impact on future sales and agent income

To date at least five companies have done this; New England Life, Phoenix Mutual, Pan-American Life, Northwestern Mutual and State Mutual.

New England's approach was a little bit different in that it required that the Policy Loan interest rate be increased at the same time.

Turning to tactical programs that are supportive of marketing strategies, they include programs for field compensation, field management, product pricing and design and some general programs.

As one supporting tactic, companies have incorporated persistency requirements in agents' compensation packages and related benefit programs for many years.

It is difficult, if not impossible, to trace the relationship between persistency emerging as a result of these programs, and what it would have been without them. The trend toward more utilization of the following programs and the general satisfaction we are hearing from LIMRA member companies is one indication.

- Many companies provide bonuses that are graded according to persistency. One pattern is a percentage of renewal premiums based on first-year commissions and persistency. Another relates that percentage to the ratio of actual to expected lapses. The most common pattern for non-New York companies is a grid which develops a percentage of first-year commissions based on total first-year commissions and persistency.
- Other companies establish a minimum persistency requirement in order to qualify for any bonuses; that requirement is typically 85 to 90 percent for 13 months.
- Some companies provide for a chargeback on commissions paid; this is often -- but not always -- associated with annualization of commission payments. In those instances when annualization is involved, chargeback is often more than the unearned premium. The chargeback is generally related to payment of 12 to 20 months' premiums.
- Some deferred compensation programs for agents have persistency requirements that must be met to earn a company contribution. One example:

-- 75 percent of business sold in preceding and second preceding years must be in force at the end of this year.

-- 85 percent of business sold in the preceding year must be in force at the end of this year, and

-- 100 percent of business sold in the current year must be in force at the end of this year.

. Several companies tie their vesting obligation on renewal commissions to an agent's persistency results.

. A few relate credits to a retirement plan to persistency.

Recently, LIMRA conducted a survey of its member companies about compensation for intra-company replacements, to determine the extent to which companies are attempting to control replacement activity. 108 U.S. and 25 Canadian companies participated; the U.S. sample included 86 career agency companies and 22 PPGA companies.

Our findings were published in a December, 1981 bulletin, and they included the following observations:

. Almost all participating companies pay full first year commissions on replacements of other companies' policies.

. Most companies pay lower commissions for internal replacements of permanent plans, or replacement of term plans by term plans.

. Most companies pay managerial overrides on all replacements.

. Most allow exceptions to penalties, generally relating to the duration of the replaced policy or to the question of whether it was in the "best interests of the policyholder".

. Among companies recently changing agents' contracts, the trend is toward relaxation of any of these restraints.

. A separate LIMRA survey of nine leading universal life companies indicates that full commissions are effectively being provided in virtually all instances where universal life policies replace existing policies.

In summary, companies are emphasizing the importance of overall persistency in their compensation and benefit programs, but they do not appear to be rigorously fighting replacement through those programs. Furthermore, many companies are not aware of replacement activity because of inadequate monitoring facilities. This subject has been addressed by an NAIC subcommittee on Lapsation Disclosure, and an industry committee, chaired by LIMRA's Helen Noniewicz, has developed recommendations for procedures and reporting formats for development of better company records on lapsation and replacement. Following a decision by the NAIC on their recommendations, LIMRA intends to begin monitoring lapse experience by all durations, instead of only 13 months.

Recognition and award programs -- conventions, prizes, and honors -- can be designed with persistency or replacement in mind. Some companies establish an overriding requirement of a defined level of persistency for qualification.

Other tactical programs relating to distribution system strategies relate to selection, training, and supervision of agents. The suitability and quality of each sale is recognized as a major factor in persistency experience. LIMRA produces periodic studies relating two year persistency to the characteristics of the buyer, what he bought, and how it was sold. A product of these studies has been the Persistency Rater, a LIMRA tool for estimating, at time of sale, a policy's expected persistency.

A recent LIMRA survey of 7,000 new policyowners reaffirmed the relationship between persistency and such factors as age, occupation, and mode of premium payment. The unique feature of this study was that it included a follow-up of these policyowners two years later, allowing us to analyze the relationship between the quality of the selling process -- as perceived by the policyowner -- and persistency experience.

This study is described in LIMRA's Managers Magazine, March 19, 1982, available from your company's senior marketing officer. Several of the findings are relevant to our discussion today:

- Among policyowners whose agents were aware of competition for that sale, the lapsation was half of that for those policyholders whose agents were not aware of competition. That awareness was associated with buying decisions by individuals who understood the policy differences and remained convinced that it was a good choice.

- Agents' characteristics played a vital role in the policy's sale and its persistency -- characteristics such as being courteous and businesslike, having a thorough knowledge of life insurance, avoiding complex and technical language, and describing policies, options, and costs openly and honestly, and avoiding high pressure techniques.

- Finally, policyholders who thought that the reason for meeting the agent related to something other than life insurance were more likely to lapse than those who understood that the initial purpose was to discuss life insurance.

Our conclusions, as presented by Dr. Elizabeth Johnston-O'Connor, are that "the knowledge and approach for an agent are critical to the persistency, and that agents who direct some of their conservation efforts to the sales process are likely to have higher quality sales and greater profitability".

Product tactics include dividend illustrations on in force business and amendment offers to increase business to obtain market interest rates for policy loans, in exchange for lower net costs. Northwestern Mutual and New England Life are two companies that have taken the "policy loan rewrite" path. And, naturally, the general tactic of product pricing and design -- within the broad strategies mentioned earlier -- can be directed with replacement in mind, either defensive or offensive.

There are a number of tactical programs relating to financial and administrative strategies, that could be helpful in the control of replacement activities; these include:

- Replacement defenses -- conservation systems -- these include agent-alerts, letters to policyholders, requests for information, and special home office assistance. An example of a comprehensive

replacement defense program, containing all of the above elements, can be found at New York Life. Another, called John Hancock Phone Power, contains a manual for telephone conservation calls, including fact-finding, preparation, and suggestions for the conversation. National Travelers also has a comprehensive program and manual.

- Policyholder surveys -- LIMRA conducts such surveys for a large number of the companies you represent, helping them identify factors that could lead to future replacement activity.

- Programs to educate policyholders and the public about the relative merits of retaining and replacing policies.

I would like to close by citing two fundamental points about replacement:

-- The relationship between consumer and agent is very important; meeting the fundamental needs of the buyer is a major contributor to better persistency; and,

-- Most replacements occur because the agent had not kept in touch. . . lack of contact makes a company very vulnerable.

My remarks today have emphasized the importance of fitting strategic and tactical replacement defenses into an overall marketing and corporate strategy; the consequence of not doing so is the creation of haphazard, short-term programs that deal with symptoms instead of fundamental marketing problems. I have also attempted to demonstrate that in certain instances replacement can be viewed positively in an overall marketing strategy. The development of that strategy is a complex and challenging process, but by completing it you will take a major step toward dealing with your company's replacement problems.

MR. GEORGE R. DINNEY: A long time ago when the late Robert Benchley was a university student, he sat for an examination in American history. One of the questions asked him to review the recent U.S./Canada Fisheries Treaty first from the standpoint of the U.S., and then from the standpoint of Canada. Benchley's reply was, "I know nothing about the Canadian position and not much more about the American position. Consequently, I propose to answer this question from the point of view of the fish."

This favorite anecdote is by way of saying that whereas most issues are presented from the perspective of the "begged question", the more discerning and interesting responses are frequently based upon a contrary perspective. There is something of a begged question in our theme "Programs to Conserve Traditional Life Insurance Policies" since the perspective is "how" when perhaps it should be "whether" or "why". My comments will address the question but with some parenthetical observations that speak to the broader questions that are implicit in our theme.

Efforts to combat replacement raise some rather basic questions of actuarial practice and actuarial ethics. The practical question is whether our conservation practices are really just placing a bandaid over a cancer. Is the objective to disguise the ailment or to treat it? If the objective is treatment, does the prescribed treatment work? The ethical question is fundamental to our profession - namely how we balance the two opposing desiderata of

equity and solvency. Any program to combat replacement of traditional business must steer a very careful course between these two requirements.

The equity/solvency riddle seems to be getting rather perfunctory treatment. Most actuaries speak glibly of doing equity to policyholders. The mutual company actuaries assert, with mock or genuine piety, that their efforts to combat replacement through "update" programs have the effect of providing participating insurance "at cost". There is room for debate that traditional policies and traditional distribution and update techniques do in fact ensure equity. The underlying reason for most update programs undertaken by Phase 1 companies is that the 10-1 rule, in the code, does not provide a good approximation for calculating the policyholder share of interest allocated to life reserves, when there is a big difference between the valuation interest rate and the average earned rate. But this problem has existed for many years. So, if doing equity means doing equity on a timely basis, then the update programs are in conflict with the equity principle. This is not an observation directed against the well-intentioned efforts of eminent companies and their actuaries but rather intended as a reflection upon traditionalism, whether in product or people.

The issue of solvency seems to have been miniaturized and deflected to a consideration of maintaining or increasing cash flows. I can understand that for many companies, with ample surplus, the solvency matter becomes transcended. Moreover, for mutual companies, where products are structured and sold on the basis of conventional dividend formulas using portfolio interest rates, the current issue of competitive interest rates becomes secondary. In effect, a company is able to replace a 10% policy in a 15% market with another 10% policy so that cash flow may seem to be the important issue.

Disintermediation of traditional life insurance is most severe for policies sold as savings instruments. In a saving (or investment) environment it is clear that when you guarantee cashout on a contractual interest basis that is lower than the current or market interest rate - and this is the case for most traditional products - then the company sustains a real loss. This real loss can be disguised by increasing your cash flow, but the underlying consequence is usually a capital loss, either because low interest portfolio assets are liquidated or because the increased cash flow is used to redeem old guarantees and, therefore, cannot be invested at current interest rates.

The second layer of the replacement problem is that life insurance companies have to face up to the matter of immunization. If assets and liabilities are perfectly matched, then a decline in cash flow could presage windup, but not bankruptcy, due to disintermediation. Immunization produces two kinds of cost. Firstly, under today's conditions, shortening up on investments means taking capital losses. The logic of doing this is that at least you can identify the dimension of your loss and absorb it as finances permit. The alternative is to do nothing which means that your investment loss is open-ended and perhaps unmanageable. The second kind of "cost" is due to the fact that while immunization may solve the problem of investment losses, it will simultaneously eliminate future investment gains that would result if the term of assets is longer than the term of liabilities and interest rates fall.

Let us agree on our terms. What I mean by traditional life policies is the life insurance product stereotypes. A stereotype policy is one which is

indivisible and wholly defined, by its terms, at issue. Under this heading I would include the American version of "Universal Life" - what I call Univoisal Life. Univoisal Life has a rigid design structure for ease of compliance with regulatory and tax standards. On the other hand, "true Universal", based on my original formulation, is modular and completely flexible.

In discussing the efficacy of traditional policies and non traditional policies, we should really enlarge the subject - which is response to replacement - to mean "response to forces of change". To gain perspective, the author Donald Schon has observed that change is taking place at a logarithmic rate, from which he concludes that reaction time is virtually zero. In that kind of environment, product must accommodate change quickly if not instantaneously. Consequently, efforts to combat replacement by use of traditional policies and traditional processes are of doubtful utility. It may well be that initiatives like "Project Update" are the last of their kind. The "Project Update" team took ten years to solve the tax problem and two years to implement the program. If change is indeed taking place at a logarithmic rate, a response time of twelve years is much too long. Common sense suggests that a problem and its solution should at least be within the same time frame.

There seems to be little recognition or understanding, as yet, that the distinctions between traditional policies and modular life insurance are diminishing. In other words, traditional policy design and traditional concepts are inching toward universality. And for the same underlying reasons, the distinctions between par and nonpar are diminishing.

Initiatives to combat replacement using traditional life insurance policies are part of a general schema which can be represented like this:

- The first element of the schema is the policy change, which is a self-initiated update program.

In the case of par policies there are two basic elements to the schema:

- Project update and its variations, which are set-piece approaches to the replacement problem, intended to be once and for all.

- Dividend enhancement techniques which try to combat replacement by emphasizing cost per M of life insurance and which rely upon a composite dividend of Y.R.T. and paid up life to produce stability in the cost of insurance over the long term.

In the middle of the schema, artfully disguised as non traditional product, is Adjustable Life, which seems to be a procedure for automating policy changes. I understand it was originally conceived to make nonpar more flexible and responsive and therefore, incidentally, to address the replacement problem. It exemplifies The Law of Requisite Variety as reported in the December, 1977 edition of The Futurist magazine, viz:

> As a system grows, it may be subject to the Law of Requisite Variety as stated by W. Ross Ashby in An Introduction to Cybernetics. This law asserts that the complexity of any policy solution must, in the long run, be equal to the complexity or variety of the problem.

The Law of Requisite Variety appeals to conventional actuaries who devise complicated problems for which they develop equally complicated solutions. The thesis is diametrically opposed to the concept of "universality", which aims at simplicity of both problem and solution.

Then we have a number of variations of nonpar which fall under the heading of:

- Update program or repricing of inforce business.

- Flexible Premium Nonpar, which is a clever means of improving nonpar cost per M for traditional products by providing for a traditional guaranteed nonpar premium supplemented by short-term rate guarantees to take account of currently favorable investment experience. Most update programs for nonpar are based on flexible premium methods - in other words, continuation of existing premium scale but with current guarantees at a lower rate.

- Univoisal Life is derived from my original formulation of Universal Life. Most people regard Univoisal as a non traditional product. However, because it is a stereotyped product it does not completely meet my standard of non traditional. It falls somewhere between the traditional product and true Universal.

What these efforts represent, collectively, is an attempt to "fine tune" traditional products to meet contemporary problems, of which inflation is one. The image we get from all of these initiatives is a reluctant, and mostly uncomprehending, movement toward universality. Moreover, par and nonpar are moving towards each other, again consistent with the idea of modularity. How is the par/nonpar reconciliation evidenced? In the benchmark paper titled "Updating Existing Life Insurance Policies" in TSA XXXII, the authors comment upon the idea of providing a portion of the dividend in the form of a series of guaranteed future annuity payments. The authors rejected this nonpar technique, partly for practical reasons and partly because they could not reconcile themselves, conceptually, to the paradox. On the subject of non-par moving toward par, the Flexible Premium nonpar policy has already been challenged by regulatory authorities on the grounds that the difference between the guaranteed premium and the current experience premium is a policy dividend. Thus, nonpar is slipping into the par category and for reasons that appear strictly rational. This metamorphosis of nonpar has serious implications for mixed stock life insurance companies because their profits on par business are limited by law.

In the case of true Universal Life, par/non-par distinctions disappear because the product is modular and adjusts instantaneously to changes in benefits, premiums, and experience. Back in August, 1981 I presented a paper titled "Life Insurance As a Game" to the 16th Actuarial Research Conference at the University of Manitoba. The paper describes a primitive computer method which will enable the uninitiate to teach himself life insurance and prepare his own financial program. In my testing of the computer program, I improvised a number of changes in amount and frequency of premium payments. Because the obvious is so frequently missed, it came as a surprise to me to be told by the computer that my basic premium had changed from positive to negative. The computer was telling me what I instinctively knew, namely

- that because life insurance and annuities are mirror images, my lump sum overpayment of premium had been converted to an annuity and

- that because of the instantaneity of true Universal Life, the par/nonpar distinction disappears.

In order to respond to the replacement problem, one must understand the nature of the threat. In his remarks, Paul Campbell refers to a LIMRA study of lapsation in 100,000 households which revealed that 48 percent of the lapses were without replacement and without intention to replace. My own company, The Great-West Life, conducted a similar study among surrendering policies with similar results. Our lapse problem was concentrated in those policies with a high investment element. These policies are inefficient at older ages and longer durations for two reasons. The first reason is that the real insurance element, measured by amount at risk, is small. The second reason is that better investment returns are available from alternative investment instruments. Consequently, at older ages such policies are satisfactory neither for protection or investment purposes.

One might argue, therefore, that the real replacement problem is concentrated in the 48 percent in LIMRA's sample who believe that life insurance is not a good buy. This should be no surprise to us. ACLI figures which show the life insurance share of institutional savings portray a steady reduction in share from 50 percent in 1948 to 13 percent in 1975. For obvious reasons, this statistic was discontinued in 1977. It seems reasonable to conclude that the heart of the replacement problem is the traditional life insurance policy sold for savings purposes. The conclusion is the same whether the policy form is par or nonpar. The answer may be in designing investment-type policies on a modular basis to permit greater freedom of choice by the policyholder as to the form of investment instrument and to provide more immediate recognition of investment performance. Traditional policies, by definition, are antithetical to contemporary investment and savings trends.

The replacement threat presented by Univoisal Life and, contrarily the value of Univoisal Life in defensive terms, can be measured by comparing the premiums for $100,000 of traditional whole life insurance, age 40, with premiums for the analogous Univoisal Life.

Traditional (average)	$16.50 M
Traditional (best)	15.50
Univoisal	9.50
Modified Traditional	11.50

Modified Traditional is the traditional whole life policy with reserve and nonforfeiture values based on the 1980 Standard Valuation and Nonforfeiture Law.

These differences are partly due to structural differences between traditional companies and "Univoisal companies". However, to some degree, the differences are even more fundamental in that they result from the unwillingness of traditional companies to accept non traditional practices. Specifically, traditional companies are reluctant to offer contemporary products. Moreover, they shy at the adoption of non traditional techniques such as variable loan interest rates. Consequently, the problems of traditional companies are philosophic as well as practical.

Life insurance is an ethereal product, so it might seem reasonable that mutual companies could "illustrate themselves" out of the current replacement problem. This would be tantamount to lifting yourself by your own boot straps.

Traditional life insurance is a practical example of the definition of faith - the substance of things hoped for, the evidence of things not seen. As long as policyholders endure in the faith, the industry will be able to overcome its problem by way of illustrations. Faith, or what might better be termed "inertia", has been the principal reason why life insurance companies have been able to maintain their traditional business during recent years.

Most companies provide dividend illustrations at issue but not thereafter. So it might make sense to project future dividends at every policy anniversary. The major disadvantage is that this would add another level of administration and cost - consistent with The Law of Requisite Variety. The alternative approach, followed by most companies, is to compare actual dividends paid with dividends projected at time of issue. In most cases, the improvement is spectacular.

However, not all companies have a dividend record they can be proud of. Two examples come to mind. One is a leading stock company; another is a leading mutual company. The stock company is one of the most enterprising and successful in North America. However, when you look at its track record you find that its par policyholders are getting the same dividends as were originally projected. Either their actuaries were remarkably prescient when the original illustrations were prepared or the company has decided that equity is a prospective, not a retrospective, concept. The mutual company is one with a public record of expense problems. This company has split its par business into old and new, with old policyholders getting the portfolio interest rate and new policyholders getting the new money rate. One would think that the old par policies would be contributing the most to corporate profit and yet the use of the portfolio rate means that they are not getting their current share of corporate surplus. So these policies are very vulnerable to replacement. Companies that use a split dividend scale - with average interest rates to some policies and new money rates to other policies - will sooner or later get caught up in the problem of what to do when the new money rates drop below average portfolio rates.

As long as we live in a "now" world, characterized by high interest rates and high inflation rates, people will have short term horizons for investment. When you reflect that dividend illustrations are most dramatic on policies having a substantial investment component but that investment has become a short-term phenomenon, you might conclude that long-term dividend illustrations should be cost oriented rather than investment oriented. That is the way dividends are illustrated under the so-called enhancement option. The enhancement option combines a Y.R.T. element with a paid-up addition element calculated at new money interest rates. The result is that illustrations of net cost per thousand are very competitive over the term of the policy.

Many companies are using the enhancement approach for sales, and the result is impressive at the younger issue ages. The problem for inforce business is that you are dealing with an older age group where these illustrations are not nearly as dramatic.

Regardless of the perspective from which you examine the replacement problem, the answer that keeps coming back is that traditional techniques do not seem to be responsive to contemporary problems. Thus, dividend illustrations may help to combat replacement but only with a shift in the traditional emphasis on rate of return towards an emphasis on cost of insurance.

It has been consistently shown that, regardless of the nature of the product, the best clients are existing customers. As a result, there have been many initiatives to recanvass inforce policyholders, usually with the intention of increasing the amounts on inforce policies rather than replacing inforce policies. Many of you are aware of a related development involving the activity of specialized mass marketing companies which offer to canvass your policyholders using successful direct marketing techniques. These efforts are either on a fee plus commission basis or take the form of a joint venture, with coinsurance of the new business.

By and large, programs to increase life insurance on inforce policies are not aimed specifically at combating replacement. They are intended to ease the lapse problem by new and vigorous marketing initiatives. Efforts to combat replacement, strictly speaking, should include offers to replace or upgrade inferior policies. However, that would mean improving policy terms at some present or future cost to the life insurance company. This is the nonpar version of "Project Update". One of my acquaintances told me that his company was engaged in this sort of cannibalism, but having regard for the cost, he told me they were practicing cannibalism on a weight watchers' diet.

As previously noted, increasing life insurance on inforce policies can be handled through paid-up additions on par policies.

A dilemma exists in the U.S. Because of the inroads of Univoisal Life, mutual companies are at cross purposes with themselves. Some mutual companies have a dividend accumulation option which provides for automatic conversion to paid-up additions if the policy becomes reduced paid-up. In the past, these mutual companies have reported the interest on these dividend accumulation funds to their policyholders with a notification that the interest should be included in the policyholder's tax return. However, because this kind of automatic dividend accumulation option (with conversion to paid-up) has an explicit mortality guarantee, these mutual companies are now asking themselves the question of whether such a dividend option is any different from Univoisal Life, designed as a fund and a guaranteed conversion option. In the scramble to produce competitive comparisons with "Univoisal companies", many mutual companies are starting to rethink their dividend philosophy with emphasis on options that increase face amounts of insurance. This is another influence leading towards gradual rationalization of the life insurance business.

The more you examine the strategies to combat replacement, the more you come to realize the heart of the matter is the attitude of traditionalism compared to non traditionalism.

The traditionalist endorses the product stereotype. The word "stereotype" comes from the Greek word "stereo" meaning solid, hence permanent (and in turn - hackneyed). Thus, the traditionalist says the life insurance policy is solid and permanent - and indivisible. If the policy is construed as indivisible, it follows that it is inappropriate to vary policy terms such as the policy loan interest rate.

On the other hand, the non traditionalist would approve the use of a market rate for policy loans if the net costs could be improved. In this regard the non traditionalist would be moving toward the modular concepts inherent in Universal Life. In fact, the flexible loan rate amendment is a direct response to Univoisal Life.

In Canada, since 1968, companies have been allowed to vary the policy loan rate. Moreover, in Canada the underlying problem of asset disintermediation is different, at least in degree. The reason is that Canadian companies are not required to provide nonforfeiture values. In recent years products called Term to 100 or Permaterm have been offered. These products do not have cash values although they provide reduced paid-up values. This "Cashless Life" product addresses the asset liquidation problem and thereby overcomes the related replacement problem.

Field compensation based on renewal persistency results is not of general value. For one thing, both in Canada and the U.S. there is de facto multiple licensing. As the conventional career agency system has declined, there has been a growing dichotomy between companies and traditional distribution systems. One result is that the agent has less loyalty and feels no compunction about switching business to another carrier.

Another point is that every agent knows that high/low is better than low/low and that high/high is best.

Still another is that a lot of business, particularly the old and vulnerable business, is orphaned and, therefore, not under the control of a company-licensed agent.

In summary, traditional methods to conserve traditional policies would work if we could freeze change forever afterward. However, it has been said that the last half of the twentieth century will be remembered as the most turbulent time in mankind's history since THE RENAISSANCE. Most of us feel that we have already experienced too much change and much too quickly. Yet we face even greater change, even more quickly during the remainder of this century. If traditional policies and methods and people are not sufficiently flexible, then their success - indeed their survival - is suspect. We would have to conclude, therefore, that our profession should direct its efforts to the design of products and systems that provide for continuous adaptation.

MR. BONDY: This is our presentation today. The panelists have talked about items other than just alternatives to combat replacement. This panel has talked about the future of the life insurance company. You might start out with certain ideas, and it is quite likely that in the end, the actions you take may be totally opposite to what you initially anticipated and not exactly along traditional concepts.

MR. DANIEL J. FITZGERALD: I would like to address the problem that both George and Paul outlined - offering current policyholders market interest rate policy loan privileges. Are companies willing to absorb the cost that is associated with that program; and that cost is the maintenance of a dividend schedule for those policyholders that do not amend to the market loan interest rate.

I believe that the New England Life program was an offer to update the valuation rate as well as the interest rate to 8% on the policy loan. Our company had studied that particular proposal, and we identified a very significant cost that would be associated with maintaining the dividend schedule for those policyholders that did not amend.

MR. DINNEY: I would just observe that it is evidence of a trend toward modularity but within the context of a traditional policy. It is my viewpoint and experience that traditional policies are very difficult to change and that they satisfy what I have identified as the Law of Requisite Variety, namely that complicated problems required complicated solutions. To the extent that using a higher loan interest rate deters the policyholder from borrowing, it may in fact improve persistency since a policy loan is a partial cash surrender and is so treated in Canada. I do not know of any company that has taken into account these persistency improvements or the improvements associated with asset disintermediation in their asset shares. That might be something that traditional companies might consider as an offset or a plus to rationalize incorporating the flexible policy loan interest rate.

I would agree with your observations that when you try to amend a traditional policy form, you end up with enormous complications. Quite often the cost associated with maintaining the system is greater than the benefits being produced. The question then is what kind of equity is being done if the company sustains a large cost to do a service to a small block of policies.

MR. OWEN A. REED: I think that the panelists deserve a word of thanks because the presentation was very well put together. Secondly, I would like to make a comment about shortening the investment term. My own company is a little more heavily into stocks and real estate than some companies are. My own perception of equities depends on how you think of the turnover of an equity portfolio. You get different results in your future projections if you look at a turnover rate that is an average of 20% a year than you do with 0% per year. We operate in one territory in Britain where it is absolutely punitive to turn it over rapidly, but that does not seem to be the case in Canada or in the United States.

The discussion that George gave us dealt primarily, of course, with what our profession could do about changing products. As you mentioned, you do not have to have guarantees in Canada. It seems that one thing that ought to be done is to try to get the NAIC to change its laws so that within 5 years we can have guaranteed values eliminated.

MR. HARRY PLOSS: George Dinney's joke about analyzing fishery laws from the fish's point of view has inspired me. I will discuss conservation/replacement from the view point of other industries.

The automobile manufacturing industry depends on replacement to remain profitable! Their declining replacement rates have severely hurt their sales and profitability. The auto executive must surely view our industry as unusual because we discourage our customers from replacing the "old model policies" with the "new models".

There are, of course, many businesses which share our concern for persistency, for example, magazines, automobile clubs, automobile insurance, mutual funds, book clubs, beauty salons and every other business that depends on periodic repeat business. It costs money to acquire new customers, and loyal customers are easier to service and are less price conscious.

Persistency had deteriorated in many of these businesses in the past few years, affected profitability and forced change and product innovation. The life insurance business has had the best persistency of all these businesses, based its distribution cost upon it, and been able to resist change for the longest time. Change will come and the more we resist it the more expensive it may be. The Universal Life compensation trend is back to our old ways. This could set our industry back several years in our struggle to survive in the future competitive environment.

The rising interest rates have contributed to our problem. Immunization calculations did not fully recognize rising policy loan/surrender rates. In this area the S&L's have a far more serious problem but have survived at least for the time being. Their balance sheet is fit for a morgue, but they have postponed bankruptcy by paying money market rates on new accounts as well as renewing accounts. Life insurance companies will have to pay competitive rates to keep their policyholder assets. Forced liquidation of investment portfolios can cause more damage faster than gradual rollover. It is important that life insurers plan their course, rather than resist change passively.

My company has set up a telephone conservation unit to conserve terminating policies last July. Many of our policyholders are delighted to hear from us. About 13% of the contacted policyholders are conserved. This represents about 1/3 the cost of new business. We do not have post conservation claim and persistency statistics at this time.

We have discussed but not implemented statistical/demographic persistency underwriting prior to solicitation. There are many intangibles which affect persistency such as service. Our surveys have picked up general information which has not been validated by actual termination behavior. We have much to learn in this field.