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CURRENT TOPICS: CANADIAN INSURANCE

Moderator: ROBERT M. ASTLEY. Panelists: CHARLES C. MC LEOD, GARY C. MOONEY, DAVID E. STEVEN

1. Product Development

   a. Unbundling of protection and cash accumulation elements.
   b. Annuity developments.
   c. New money insurance.

2. Financial Considerations

   a. Impact on investment policy.
   b. Trends in future company profitability.
   c. Can term be profitable?
   d. Term insurance.

3. Management of Existing Business

   a. Enhancement programs.
   b. Improvement in rates for existing term policies.
   c. Active replacement programs, both internal and external.

4. Outlook for Field Force

   a. Impact of commission and premium reductions.
   b. Opportunities for improvement in agent productivity.
   c. Need and/or opportunity for agent to have additional sources of income - group, property and casualty, other.

MR. ROBERT M. ASTLEY: Many people believe that the life insurance industry is going through a period of profound change. Our traditional markets are static at best, possibly declining in real terms. Product mixes are changing rapidly. Investment policies and practices are being questioned on every front, and traditional methods of distributing our products are under attack. However, these changes do not affect all companies equally.

Our approach this afternoon will be to view some current issues in the context of the profound changes which appear to be taking place. We will do this by having each of the three panel members play a role as chief executive officer of his company, making a report to the Board of Directors. These reports will "tell it like it is", with both good news and bad news.

Let me introduce our three panelists. Charles McLeod is Actuarial Vice-President with Manufacturers Life. Ted Steven is Director, Individual Products with Great-West Life, and Gary Mooney is now President of Mooney Associates, his own consulting firm.

I do wish to emphasize that the panelists are not speaking on behalf of their employers in real life.

Beginning the role-playing, let me introduce Charles McLeod, President of Steadygrowth Life. Steadygrowth is a large mutual company operating predominantly on the career agency method. It has been reasonably progressive. Charles was formerly the chief actuary and his main concerns revolve around the financial health of the company.

MR. CHARLES C. MCLEOD: Members of the Board, if one looks only at the immediate surface, the prospects look very encouraging, not just for our company, but for other similar companies. I say this for the following reasons:

1. Sales of individual life insurance have been rising steadily. The face amount of life insurance sold in Canada in 1980 was $37.3 billion, an increase of 15% over the previous year and an increase of 100% over 1975.

2. Sales of annuities in Canada have been rising even more rapidly, helped by favourable tax treatment; for example the deferral of tax by the policyholder on investment income on deferred annuities, sales of RRSP's, and sales of income averaging annuity contracts. Annuity premium income was $1 3/4 billion in 1980, an increase of 37% over 1979 and an increase of 175% over 1975.

3. Recent legislative changes have resulted in Canadian companies having even more freedom of action than before, especially compared to the situation in the United States. The changes in financial reporting, permitting the use of "adequate and appropriate reserves" mean that surplus strain, especially for a well established mutual company, is normally only a minor concern. We still have a policy loan problem for old policies, but now that we may charge up to prime rate plus two percent on new loans, this will become less of a problem.

4. Experience on mortality, expenses and interest has been very good, generally showing improving results and/or results better than those assumed when setting the premium rates.

   The Society of Actuaries' Intercompany Mortality Study shows the aggregate medical mortality ratio declining from 92.9% of the 65-70 Select Basic Table in 1972-73 to 75% in 1977-78.

   Despite high inflation, the increasing size of new policies has resulted in only a small increase in unit expenses. The C.I.A. expense study shows an expense ratio for the large companies rising from 98.6% in 1976 to 106% in 1979, an increase in unit costs of about 2% per year.

   With the rapid rise in interest rates, portfolio rates have also risen. It is dangerous to generalize here since some companies, who invested long in bonds and mortgages, will be holding assets whose market value is considerably less than

book value. Nevertheless, provided a company has invested wisely, it will be earning substantial profits from investments.

Unfortunately, lapses show a worsening trend, and I will have more to say about this later.

Despite this apparently bright outlook, it would be foolish to extrapolate the increases in profits and new sales we have seen in the last five years, or even to assume that profits will remain the same. There are a number of serious issues which threaten us.

1. Although, as I just mentioned, rising interest rates have increased profits on our inforce business, the current levels of new money rates make our existing business very vulnerable to replacement. Our company and others have adopted "enhancement programs" whereby the face amount, but not the cash value, of our older policies has been gratuitously increased. While this has won us some public relations points, any enhancement program runs the risk of suggesting to a policyholder that he review the benefits of a policy he may have forgotten about. Furthermore, an enhancement program must be very generous to make it more attractive than applying the cash value towards the purchase of a new single premium contract, or if permitted, borrowing the cash value under a 6% policy loan.

   Older term policies, which often have an embarrassingly low claims ratio, are also vulnerable to replacement in view of the recent drop in rates for new policies. If we do not offer lower term rates to our existing policyholders, an agent from another company probably will.

   Thus, one way or another, we cannot expect to see a continuation of high profits on the older inforce policies. Either we must offer generous enhancement programs, or we must expect large numbers of policies to be lapsed, surrendered, or borrowed against at low rates.

2. With our current high and volatile interest rates, is the conventional whole life contract still viable? I suspect not and I see a move towards unit-linked contracts and an increase in the trend towards unbundling into term and annuity portions. Unbundling presents the following problems:

   (a) Helped by a sudden, and widespread, introduction of non-smoker's policies, term rates are being reduced to such a low point that while term is not (yet) a loss leader, any profits to be earned will be relatively minor. In addition, whereas mortality used to be a relatively simple assumption to make, there are a number of gaps in our knowledge about non-smoker/smoker mortality differences. How does the ratio of non-smoker/smoker mortality vary by age? By time since ceasing to smoke? By sex? A lot of guesses are being made, and this makes

me nervous, particularly when profit margins are so thin.

With low term rates and the traditionally low commissions on term, can our agents survive through selling only term? I shall return to this point later.

Finally, even if large numbers of term policies are sold, how long will they remain in force?

(b) The outlook for annuities is brighter since it gives us the chance to build on our traditional strengths in investments. But even here there are dangers. Competition is increasing, not merely from other insurance companies but also from trust companies. Despite the Canadian life insurance industry once having had a significant share of the RRSP market, we estimate that Canadian life insurance companies now have only 10% of the market, with 80% being held by banks and trust companies.

In the non-registered deferred annuity market, we are heavily dependent upon the favourable tax treatment to the policyholder I referred to earlier. I think it would be foolish to assume that life company products will indefinitely continue to have a tax advantage over similar products being offered by banks and trust companies; and if we lose this advantage, our sales will surely drop off.

Our share of the immediate annuity market could also drop if trust companies are given additional powers and/or learn how to apply immunization theory.

Commissions on annuities are trending downwards towards 2%, placing further pressures on our agents' incomes.

3. The price of our products is becoming a much more important part of the buyer's decision. The unbundling I referred to earlier has made it much easier to compare the cost of different companies' products, and the consumer is being helped by an increasing number of articles on insurance in magazines and newspapers.

   Among agents, single company representation has almost broken down. Experienced agents, while perhaps placing most of their business with one company, increasingly "broker" the balance with other companies. These agents, when trying to develop accountants and lawyers as clients and/or centres of influence, will use as a selling point the fact that they are able to obtain the best rates.

4. I mentioned earlier that the combination of unbundling and lower commissions on annuities can lead to lower incomes for agents. While our senior agents are adaptive enough to survive, either through charging fees, selling additional product lines or through increased productivity, there is no simple solution to the establishment of new agents.

What does all this mean to us?

1. We must be prepared to spend a lot of money in the next 2 to 3 years in redesigning our rate manual. Together with this, we will need to extensively retrain our agents, managers and support staff. For example, guaranteed cash values may be almost extinct on new products within five years.

2. We must make our products simpler so that existing salesmen can sell them faster, and new salesmen require less training.

3. Our agents may need to diversify into other product lines, for example property and casualty, in order to maintain their present income levels.

4. Significant changes in our investment policy will be required as we move towards:

   (a) More new-money contracts with small or no guaranteed cash values, but with very small profit margins.

   (b) A shortening of renewal periods on deferred annuities.

   (c) Increased sales of unit-linked policies.

5. We must be prepared to see reduced profits on our inforce business, either through introducing enhancement programs or watching the business go off the books.

Despite this, I am still positive about the future:

1. We have the financial resources to implement the changes that will be required.

2. Unlike most other financial institutions, we have an excellent distribution system in place in the form of our agency force. This is the envy of other institutions since the cost of developing it from scratch would be enormous.

3. There is, and also will be, a demand for life insurance protection and savings vehicles, although not necessarily in the form of products we have traditionally sold. If we design and price products so that the consumer wants to buy them, the increased sales can compensate for the reduced profit margins.

MR. CHRIS H. MCELVAINE: In my role as a long-standing policyholder of this marvelous organization, I heard another policyholder at the annual meeting mention that he has taken advantage of his 6% policy loan provision. He has reinvested that money with the same company in an RRSP five-year interest certificate bearing a phenomenal rate of interest. Apparently he has been doing this for 4 or 5 years. My question to Mr. McLeod as President of the organization is "Why has he not informed me as a policyholder that I could do this?"

MR. MCLEOD: This question has been asked of many insurance companies over the last few years. The reason, of course, is that the companies cannot afford to do so. Some companies want to try to recognize policy loan utilization in the debiting system or through some form of special bonus. I believe there will be pressure on companies to make a distinction in the dividend formula between borrowers and non-borrowers.

MS. HELEN NONIEWICZ*: Do you expect to recapture any of the RRSP market from the trust companies?

MR. MCLEOD: Yes, but we will have to pay much lower commissions, perhaps at the 1% level. It may be necessary to consider other distribution systems. Using one's own agency force limits the available markets. An agent will not go out of his way to obtain a $3000 RRSP sale at a 1% or even 2% commission rate. He would receive a larger commission for an income averaging annuity contract.

MS. NONIEWICZ: It surprises me that little has been done to recover the market since it was lost in 1974.

MR. MCLEOD: At about that time the income averaging annuity market came into existence in Canada. This has replaced the RRSP market for most agents. However, there is still $3 billion going into the RRSP market.

MR. ASTLEY: Ted Steven is the President of Spectacular Life, which is a large stock company with several systems for distributing its products - career agency, brokerage, and experimental mass marketing. Ted rose up through the agency and brokerage marketing side of the business. His primary concerns involve the viability of his distribution systems.

MR. D.E. (TED) STEVEN: Ladies and Gentlemen of the Board: Over the recent months we have developed a proposed course of action to address both our current and anticipated circumstances with particular focus on the distribution of our products. Details of the strategic and financial implications will follow, but for the next few minutes I want to review with you the fundamental elements leading to this recommendation.

First, consider the end-user of our products - the consumer. Buyers of life insurance are increasingly aware of product alternatives available today. They are better educated, understand our products more fully, and have advisors who are openly critical of many aspects of our business. Because of economic uncertainties, their time horizons are shortening, and their demand for immediate and competitive returns and costs continues to grow. In short, the consumerist movement is a reality in our industry, and each company must respond to these new and changing demands.

*Ms. Helen Noniewicz, not a member of the Society, is with the Life Insurance Marketing Research Association.

The distributors of our products, both our own career agents and the brokers with whom we deal, must be considered both as consumers and salespersons. As consumers, they are also subject to the current economic pressures of inflation and high interest rates, and are demanding responses to meet their personal needs. Over the past decade, the pressure on agents' income has been enormous. The shift to term products and the reduction of term rates has reduced compensation per unit of face amount. Reductions of commission rates, particularly for deferred annuity products, has been dramatic. In spite of these factors, agents' incomes have kept pace with inflation, by and large, through increased effectiveness and larger average sales. New money and universal life products emerging recently carry similar effects into the permanent insurance marketplace - lower premium levels and lower commission rates for the same amount of protection as before. Career agents can no longer afford simplistic company loyalty - we must earn the right to their business, as with brokers, through a viable combination of products, compensation and service - and keep it current and contemporary.

As a salesperson, the agent or broker must provide clients with the products and services they need and will accept - if we do not offer it, the distributor will look elsewhere for a source of acceptable merchandise. As consumer attitudes change, so will the attitudes of the agents and brokers who serve them. Today, the competition for an agent's business, including both new and existing policies, is at least as keen as the competition for a client's business.

Corporate results evidence these observations. Significantly improved sales have resulted from product changes which offer high customer value in a contemporary form. Conversely, high levels of cash surrender and loan utilization indicate financially selective disenchantment with traditional product forms in today's circumstances. However, as better-value products are sold and older business terminates, future profitability becomes increasingly dependent on growth in our total business base, not just growth in new sales.

In simple terms, we are really in two kinds of business - either we assume a specific risk for a specific period at a specific price (pure term insurance, for example) or we are managing the investment of assets for our customer (as in deferred annuity). All our products can be analyzed as one or the other, or, in the case of permanent plans, some predetermined combination of both. These two functions are our basic sources of expense and profit margins. As consumerism and competition require lower risk costs and better savings returns, our margins necessarily shrink. In addition, with current high interest rates, the present value of future margins from all our business is reduced. This problem is compounded by poorer persistency, which lessens the probability of recovering these margins. As the real value of our margins reduces, high acquisition costs become increasingly uncomfortable.

Solutions to agents' income problems in the context of higher first year commissions are unacceptable without some added quid pro quo such as chargebacks for impersistency.

In addition to our risk and asset functions, since we design and package what we sell, we are the arbiter of how each premium is shared between the customer (for benefits and policy values), the agent (for compensation) and the company (for expenses and profits). One could characterize many of our problems in terms of the balance or timing of this sharing process being inconsistent with the requirements of the market, the distributor or the manufacturer.

For example, where the public perceives a contract to contain an inherent savings component, they find low early cash values increasingly unacceptable. Similarly, they expect to see claim payments on disability income policies bear a reasonable relationship to premiums paid through disclosed loss ratios - a concept which might easily be extended to term life insurance.

Both agents and brokers are being approached to solve their immediate income needs with attractive out-of-house bonuses for their new business and full compensation for replacements of business currently carried by any other company.

While trying to meet the demands of both the customer and the distributor, companies are also wrestling with escalating business costs and declining values of future margins.

Focussing on the fundamentals of risk assumption and asset management provides a potential solution to the dilemma we face. Each function provides a margin for operating costs which can be shared between the company and the distributor. In other words, whenever we accept a risk premium, from old or new business, a provision in excess of expected claims should be available. Similarly, whenever we maintain an invested asset over a period of time, whether old dollars or new dollars, there should be an excess of interest earned over interest paid. Where the two functions are pre-packaged in a permanent product form, it would be reasonable to presume that a portion of every premium, whenever received over the life of the contract, is available. These observations translate into the simple concepts of <u>level lifetime commissions</u> for insurance products and <u>level lifetime asset-based compensation</u> for savings accumulations - our proposed course of action.

While there is no precedent for a complete compensation system of this nature in the life insurance industry today, it is the norm for property and casualty insurance, and many of our current products have similar compensation attributes. Some renewable term products are recommissioned at every renewal. Many locked-in deferred annuities are commissioned at each renewal on the full accumulation - the amounts paid are equivalent to discounted locked-in "margin shares". Agents and brokers can effect

continuous compensation on permanent participating premiums by having dividends carry policies sold 10 years ago and selling new coverage for the premium the client is accustomed to paying.

Years ago, disability income policies provided for a level commission on every premium; that changed to conform to life insurance patterns. External alternatives may well impact the traditional high-low standard we know today, and many changes are in the direction we recommend.

The proposal is daring and expensive - before considering details, we must recognize that our distribution capabilities would be at risk - a loss we would not recover from quickly, particularly on the career agent side. With that in mind, let us review some advantages and disadvantages this change would engender for the consumer, the distributor and the company.

The consumer effect would be evident in both product and service. Renewable term and deferred annuity products would change little as they are similarly compensated today, while disability income rates would be improved. The significant change would impact permanent insurance plans which would all have high immediate affordable cash values.

Concurrent with these changes, we will introduce higher policy charges to provide both simple rate banding for large vs. small amounts, and an added margin which can be shared with the agent. We will also heavily promote maintaining protection levels (and premium income) on a current basis through indexing options and flexible guaranteed purchase options. Research has already commenced on how we can best provide homeowner and auto coverages to policyholders in addition to life, health and annuity products. On the service front, with all premiums and all accumulations equally compensated, the consumer could expect more regular attention, and a continuing relationship with the agent.

We believe most career agents and many brokers will react positively to the proposed system. While other incentive programs will remain, the first year commission for new sales will reduce dramatically. For most agents, this will mean extended financing at a corporate cost - for mature career agents, a transition program to finance cash-flow needs relative to today's compensation system until their business base is self-sustaining. These periods should not extend beyond five years, considering a reasonable level of sales activity together with the increasing effect of level compensation on renewable term and deferred annuity. Increased benefits purchased to counteract inflation through indexing or guaranteed purchase options will act to shorten financing and index the agent's compensation.

Once an "affordable" business base is attained, our agent will achieve a stability of income impossible under current systems. Instead of starting each year with renewals at 20-30% of annual income, perhaps 80% or more will be based on existing customers, provided they maintain their programs. In essence, the agent

will have built a business not unlike other professionals (such as dentists, lawyers, etc.), by attracting and continuing to serve a base clientele. Additionally, this business is of real value, as the agent could sell the right to lifetime commissions, similar to the situation in a general insurance agency.

The brokerage impact is more uncertain. Some who deal for a particular product will continue, while others will conclude they cannot accept the short-term income loss and turn elsewhere. Still others may effect their own transition as they can afford. The improved products and positive long-term attributes of the system may attract different brokers, particularly general agents. The absence of financing must be offset in large measure by effective products, promotion and improved service capability.

Corporately, we will be measuring and compensating exactly what counts in our financial affairs. While we will not eliminate the risk of impersistency, the commission element will be shared by the agent. We are increasing the financial risks associated with agent financing, which will necessitate more selectivity and control than exists today for a longer period and with more available funds. In addition, we will require heavy investment in branch computerization of all aspects of our business to establish a superior position in the ease and speed with which agents and brokers can quote, place and service our customers. Finally, if warranted, the costs of adding property/casualty products must be supported.

In conclusion, the proposal merits proceeding, despite the risks involved. It offers a unique combination of product, service and compensation which will better meet consumer needs and demands, and establishes a mutuality of financial interest between the customer, the agent and the company which does not exist today.

MR. WALTER N. MILLER: I would like to ask Ted what the reaction has been of the people in his marketing department and field force with whom he has discussed this proposal.

MR. STEVEN: I have discussed this with quite a number of agents, but no brokers. The degree to which this attracts the agents is surprising. If the agents had the assurance that they would be adequately financed as long as they were providing an acceptable result, they were very interested.

MR. H. IAN MACINTOSH: What do you see as being the level commission equivalent to 60% in the first year, and 9 years at 5%.

MR. STEVEN: A given commission scale can have significantly different present values under different circumstances. I would suggest that it would be anywhere in the 10 to 20% range depending on the product.

MR. ASTLEY: Ted, one of the five alternatives that Jim Anderson put forth yesterday for solving the financial crisis in distribution systems was to consolidate and do exceptionally well with your existing distribution system - in effect to run it better than anyone else within a particular market niche. This almost seemed to imply a concentration on a career agency method. One of his other alternatives was to concentrate on the brokerage market and provide nothing. Would you see the proposal falling in line with that kind of strategy which would tend to diminish the importance of brokerage business?

MR. STEVEN: That again would depend on the product. Certain brokers will provide their client with the product regardless of the compensation involved, particularly if the product is unique.

MR. CALVIN C. JORDAN: If I read our statement last year correctly, our average annual premium was only about $300. The level commission is intended to motivate the agent to give ongoing service, but it would be difficult for the agent to drive across town for $50 a year.

MR. STEVEN: I think a lot of policies will persist without a drive across town. However, an agent who is established will earn just as much on a level commission system as on a heaped system.

MR. JORDAN: Have you considered the impact of inflation?

MR. STEVEN: Yes - in fact if the same rate is being paid on every dollar, a yearly renewable term policy, for example, would have increasing commissions. If there were an indexed rider as well, the commission could more than keep pace with inflation.

MR. ASTLEY: Gary Mooney is the President of Upstart Life, which is a small stock company obtaining business primarily from brokers. The company has depended on attractive reinsurance packages in order to market aggressively priced term insurance.

MR. GARY C. MOONEY: Ladies and Gentlemen of the Board: At our last meeting, you asked that I prepare a report that would provide an overview of issues facing us today and an indication of any major changes that I believe will be required over the next few years to deal with these issues.

I would like to begin by briefly summarizing our company's history.

Since we opened our doors for the first time less than 10 years ago, we have focussed our attention on individual life insurance products and on the broker market.

We have been offering products that the brokers want, particularly large amount term products, and have priced these products to be very competitive.

Because our retention limit is relatively low and our capital and surplus relatively modest, we have transferred much of our mortality risk and surplus strain to reinsurers, one in particular.

This approach - term products, brokers and reinsurance has worked well for us, particularly in terms of growth. We have exceeded our targeted growth rate in every year of our existence.

More recently, we have had some success in introducing adjustable products and deferred annuity products to our market.

We have had difficulties at times as a result of too much sales success, which has resulted in a backlog of new business to be processed and some complaints about service. However, we have been able to depend on our staff for an extra effort when these problems have occurred.

We have been able to adjust quite well to changing circumstances in the market. For instance, we were one of the first companies to introduce an attractively priced non-smoker's product.

Our ability to adjust is based on several factors - the simplicity of our operations, the versatility and quality of our people, the assistance we have been able to obtain from our reinsurer and the advice and technical help that we have received from our parent company. In addition, we have not felt particularly restricted by the need to maintain the status quo in respect of our inforce business as it has been quite modest in size.

One of our strengths in the past has been in not trying to be a mini version of a large company. We have picked our spots and have been quite successful in operating in these limited areas.

We could probably continue with this approach for some time with some success. However, I am concerned that this success might be more apparent than real, more short term than long term.

I believe that our industry is in the midst of a period of change unlike any period in the past. This has come about because of major changes in economic conditions, because of an oversupply of companies in our industry and because of the increased sophistication of agents, brokers and the buying public.

I would like to spend a few minutes outlining where I think the industry is going - at least that part of the industry that relates to our markets. I will comment on four areas - products, marketing, investments, and administration.

Where the Industry is Going

In the product area, competition from both inside and outside the life insurance industry, as well as consumer pressure, has led to an unbundling of the traditional life insurance products into their component parts--protection and savings.

These simpler products are more easily compared and, therefore, subject to even greater price competition. As a result, we have seen rates decrease steadily over an extended period of time.

Economic conditions - first, high rates of inflation and more recently, high rates of interest have encouraged people to shorten their planning and investment outlooks, with the result that the market has been demanding shorter-term products. The industry has been meeting the demand while, at the same time, worrying about the implications of this shift in emphasis on their inforce business and their future profitability.

Brokers and agents, in response to these changing circumstances, have increasingly been moving policies from one company to another, and benefitting policyholders and themselves in the process. This practice has become so widespread that one might be forgiven for thinking that we have built the first perpetual motion machine.

However, once we look beyond the symptoms--unbundling, shorter-term products and mobility of policies, we can see that the life insurance industry is being viewed by many in a new way. The industry is increasingly being looked upon as providers of short-term, price-competitive coverages or modules that are inserted into an individual's total financial plan.

While the price is right and certain conditions prevail, these coverages or modules are maintained. As soon as any of them becomes outdated it is replaced by something more up-to-date.

Companies are responding by offering products that provide for automatic review and updating to keep them current. Many of the newer products - renewable term, adjustable life and RSP savings products - contain this feature - offering reassessment of both price and conditions, most commonly every 5 years.

The individual needs a framework or system to use in managing this collection of modules over the years. Some companies are starting to provide the framework as well as the coverages through products with names such as universal life, total life, and the like.

What we are seeing is the emergence of a new approach to the provision of life insurance products - the systems approach. There is a good chance that the systems approach will revolutionize or at least evolutionize the industry.

In the marketing/sales area, there is a continuing trend towards the establishment of unconnected (broker) or loosely connected (general agency) sales organizations throughout the industry. These organizations are becoming larger, better equipped, and more productive. Because they control a large amount of business, they have greater influence on the life companies with which they deal or might deal.

There is continuing downward pressure on compensation levels as a result of rate competition and as a by-product of unbundling, which makes the commission structure more visible. Perhaps not coincidentally, brokers and general agents are moving policies more frequently, possibly obtaining a first-year commission several times over the life of the "policy".

In the investment area, there is a continuing trend towards diversification into a wider variety of investment vehicles.

There is a major shift towards shorter term investments to match the shorter term products. In addition, increased attention is being paid to cash flow management and techniques of immunization as a response to volatility of sales, policy loans and surrenders, and interest rate levels.

In the area of administration, the computer revolution now underway is having an impact on all areas of our business - from product design to sales activities to corporate planning.

People are being conditioned in their everyday lives to expect information in real time - meaning right now.

Facilities are now becoming available to allow our industry to provide this type of service - excellent software tools, distributed processing, public data transmission networks, small inexpensive business computers, videotex and so on.

We will soon find that everyone - policyholders, agents, and even company presidents - will become quite demanding for immediate access to information.

In addition, they will expect fast turnaround on transaction processing - days instead of weeks, hours instead of days.

Where does all this leave us? We are a small company that cannot significantly influence the market. But we can identify trends in the market, project them and exploit them.

First, I think we have to recognize that (to paraphrase Alvin Toffler) we have entered the "post whole life society". Then we need to define this new society as it pertains to our company.

Where our Company Should Go

One of my colleagues, another CEO, recently stated that every life insurance company could and should have made money over the past 100 years. He is not prepared to make the same statement about the next 100 years.

Life (pardon the pun) will be particularly difficult for smaller companies like ours. Because of the volatility of almost every aspect of our business it will be essential to have a larger, more solid and less volatile base for the future.

We must ensure that our products are designed in such a way that they will be upgradable or convertible to a systems approach as described earlier.

We need to design into these products protection for the company against their inherent mobility by such techniques as front-end deposits, flattened compensation schedules, and surrender penalties or persistency bonuses.

As a start, we should begin experimentation with a systems approach to our product line by developing a universal life type of product and testing it in the market.

We should plan to offer both the traditionally packaged product line and the systems packaged line (that is, universal life) for some time, thereby leaving our options open.

In addition, we should investigate other lines of business for their potential -- group, creditor, even property and casualty insurance as possible additions to our base of operations.

In the marketing area, we should actively explore additional means of distribution. In particular, we should begin to build a managing general agency type of operation, the idea being to develop a distribution vehicle that has more contractual ties with the company.

We should also look at the possibility of mass marketing or joint marketing ventures as other sources of new business.

Regarding the investment area, we need to consider ways of expanding our investment capabilities, both in terms of staff and our ability to participate in a variety of investment vehicles.

This expansion might be achieved through an increase in in-house staff, use of outside investment counsel, participation in joint ventures, or some combination of the three.

Last, but certainly not least, we need to plan for a major restructuring of our administration systems to utilize the computer capabilities of the 1980's. If we plan properly we can leapfrog much of the current technology that will shortly become obsolete and be ready to use the new technology as it comes on stream.

These then are the major issues as I see them, together with my suggestions for dealing with them.

Earlier I mentioned that picking our spots has been a source of strength in the past. For the future, we shall need a broader base of operations to ensure our survival. Small, narrowly oriented undercapitalized companies will not make it.

Finally we arrive at the bottom line - the need for more capital. If we are to deal effectively with my suggestions we shall have

to obtain a substantial amount of new capital to allow us to finance development of this stronger base.

Remember some of the items:

- new individual product development
- possible expansion into new lines of business
- addition of new distribution methods
- enhancement of our investment capability
- heavy investment in new computer facilities

Fortunately, our parent company is generally willing to make new capital available if they are convinced of a good return. In addition, we may be able to obtain some assistance from our reinsurer.

We will obviously need to study these suggestions in depth before we proceed further. As a starting point, I would be very interested in your reactions to my comments.

MR. ASTLEY: I can certainly detect a number of common threads in the presentations of the three individuals - they talked about unbundling, they talked about persistency problems, the diminishing loyalty amongst distributors of our products, and concerns for existing business. Some would argue that we are the authors of our own misfortune. As Walt Miller said, he has not received one single letter asking for an unbundling of the product. I would be interested in hearing from this group - are we in fact leading ourselves down the garden path, or are we simply reacting to the winds of change over which we have very little control?

MR. MCELVAINE: Mr. Mooney, my role has changed, I am a member of the holding company of the Upstart Life. I think this is the third or fourth meeting I have attended where you have talked about the need to provide more capital for the expansion of computer facilities and for the expansion of staff. You have told me over and over about the difficulties of these strange words like disintermediation that you use and the investment risks involved in the life insurance company. I have a brother who operates out in Calgary, and he is involved in a life insurance company which is called Prairie Pacific. I understand their operation is not really unlike ours, the only difference being that I believe we retain 1% of the business that passes through our hands, the other 99% going to reinsurers, whereas my brother's operation retains none of the business, 100% of it passes through their hands. Now, would we not be better off to establish an organization that passed through 100% rather than retaining 1%?

MR. MOONEY: This is certainly an alternative for us. I think as a company we have to decide our real function. Historically, life insurance companies have been companies that have accepted and managed risks. That certainly has changed to some extent. I think some of the smaller companies backed by reinsurers have

been very successful-essentially marketing life insurance for the reinsurers and accepting in return a guaranteed return for their efforts. We have to decide if that is the route we want to follow. I am suggesting that it is not to my mind appropriate at this stage to give up the idea of being a company that accepts and manages risks.

MR. MCINTOSH: Gary, your company has been specializing in the brokerage market, and for a while you were very successful because you had the lowest term rates last February for three or four days. I understand that you had a lot of applications at that time and you haven't got all the policies issued yet, but hopefully later this week you are going to do that. Are you going to bring your rates down again and have another spurt of business coming in?

MR. MOONEY: In the short term we may well have to do something like that to realize some growth targets. We need some premium income, and although it may be relatively thin in terms of margins, we do have a very good reinsurance deal.

MR. STEPHEN R. HAIST: Charles, we are anticipating low-commission products coming out with a better deal for the client. Do you not anticipate a very large replacement problem? If so, what action would you take to prevent that, particularly when you do have a great deal of surplus recognized or unrecognized sitting around with which you could give a substantially better deal to your current policyholders?

MR. MCLEOD: Replacement is going to happen whatever we try to do. Basically, we should be trying to come up with products that are attractive to new policyholders. Some surplus should be diverted towards improving benefits on existing policies. The key question is how much surplus one needs to divert to existing policyholders. If one keeps worrying about what happens to one's existing block of business, it is going to hurt you in the long run.

MR. HAIST: I agree with you there, but as a mutual company you are supposed to be trying to establish equity between the policyholders. Do you not think that you should be substantially improving the lot of your existing policyholders? I am not arguing that you should not introduce these new lines.

MR. MCLEOD: It is a question of how much surplus one is to distribute. Although surplus belongs to the policyholders, one must maintain a certain amount of surplus as capital for further development, and as a margin against future contingencies. Yes, we should probably be giving more surplus back to existing policyholders, but I think in the long run they could be given back too much. They would be members of a company that was weaker financially. The trick is to give money or better benefits to the existing policyholders and yet encourage them to keep their business in force. This is what some of the enhancement programs have tried to do. They have given extra insurance without

increasing the cash values, as an incentive for the policies to stay in force. They may in the long run generate better benefits and higher profits for the company as a result.

MR. ASTLEY: I think that if there has been one single factor in 1981 that has impressed me, it is that the company I work for and many other companies are spending a lot more time actively thinking about and actively managing their existing portfolio. This is evidenced by the enhancement programs that have been coming forward, the term insurance question and in my own company, blocks of policyholders where it was clearly in every policyholder's interest in that block to make a change. If I can digress and mention one, we had identified a group of pension with insurance plans where the cash value exceeded the original death benefit so there was no remaining net amount at risk. They were still premium paying and were being credited with the portfolio average weight of return. We wrote to all of our agents, sending them lists and suggesting they replace these with new flexible annuity products at a higher rate of return. One could argue that on the grounds of equity all day, saying that the participating block is being hurt by taking away that cash flow or those assets. But these questions are, in my mind, going to be more and more with us over the next several years as we go through this period of change, and I would ask any of those who are present, from companies that have undergone enhancement programs, to comment on them.

MR. JOHN A. MEREU: I have a question for Ted Steven. You seem to be advocating the same rate of commission for first year premiums and renewal premiums and for the savings dollar premiums and the term dollar premiums. Is it really possible to give the same amount of commission on the savings dollar when the insurance industry is in competition with other savings companies?

MR. STEVEN: No, perhaps I was unclear. I segregated this proposal into level commissions on insurance, and asset-based compensation on accumulations. I would see compensation in the neighbourhood of ½% for every dollar that stayed 1 year.

MR. MEREU: Is there then a single rate of commission for insurance, and a single rate of commissions on asset accumulations?

MR. STEVEN: Where the term is pure or where you have packaged the whole life program you could afford to pay a flat percentage commission on every premium.

Where the savings program was pure, you could not do that. For instance, if you were prepared to sell a retirement income contract, you could probably afford to share 10% or 15% of the premium with an agent every year, whereas if you sold a pure deferred annuity you would be paying the agent approximately ½% on every dollar of the balance for each year the dollar stayed. So it would be quite different.

MR. ASTLEY: Ted, would that lead you in the direction then of having commissions on a universal life type product, if there was such a think in Canada, equivalent to commissions on term insurance plus commissions on deferred annuities?

MR. STEVEN: Yes, if the product were unbundled, the compensation would be unbundled.

MR. MAURICE GERMAIN: We did the same think as Mutual for our annuity policies. Perhaps because we are mutual we believe it to be to the benefit of our policyholders.

MR. STEVEN: I will step out of my role now and back into my normal work position. I represent a stock company with a significant par line of business and we have been very tempted to do exactly the same thing. We think it is quite equitable to the policyholders, but we are not sure that the Superintendent would understand rolling several hundred million from the par account to the non-par account. The thought process is not restricted to mutual companies, but we have a modest degree of concern as to whether the motivation would be interpreted correctly or not because a good deferred annuity is non-par and the old ones are par.

MR. ASTLEY: It would certainly depress your net earned rate on the par portfolio for a while.

MR. MILLER: I would like to ask any or all of the panelists whether your valuation actuary has recently come to you complaining about the tremendous pressure that you are putting on him to help you generate some internal funds to finance your various plans.

MR. MCLEOD: No. With the new valuation basis we can write significant amounts of new business with very little valuation strain. The situation is different in Canada than in the United States.

MR. STEVEN: I agree, we do not have that kind of problem.

MR. MOONEY: In many cases there is still enough room in valuation on existing business that some of the reserve could be freed up and used to finance new business. I expect that there will be some pressure to do that over the next period of time.

MR. MILLER: I am encouraged to hear what is said. I would only offer a bit gloomier personal opinion as I look over some of the things that we have been doing and thinking about with respect to New York Life's Canadian operation, and some of the trends that we perceive which are essentially similar to the things that we have heard said this afternoon. I am getting very worried about where we might really be going in terms of pressure on the actuary and questions of actuarial responsibility as we get to deal more and more in the area of investment-related products with some very exotic ideas which are either forced on us by the marketplace or which we pat ourselves on the back for

dreaming up so that we can surprise the marketplace. I think many of us with valuation actuarial responsibilities might not be so happy over the next couple of years in terms of the degree of conservatism that we are going to build into our assumptions.

MR. MOONEY: Let me step out of my role and comment as chairman of the financial reporting committee. We are looking at a lot of issues right now and are getting more and more into the asset side. I expect that that is going to become a major topic for us very soon. We have also been spending a lot of time dealing with the question of changes in valuation basis and the impact that might have on the income statement and the impact it might have on the balance sheet. We do not have any answers yet - it is a very difficult subject but a few of us who have already been in situations where we felt it was appropriate to weaken our valuation basis realized that there is an awful lot of scope left in the hands of one person, and we really need some good solid theory down on paper for people to follow.

MR. ASTLEY: This is an important question and certainly the Individual Actuary in my company is very concerned about the possible effect of replacements at today's interest rates and with capital values on fixed income securities being at very, very low levels. Companies may indeed, over the next 2 or 3 years have less surplus than they have now.

MR. MCLEOD: If I could just respond to an earlier question about enhancement programs, I will step into my normal role at ManuLife, and describe briefly what we have done. Last year we improved benefits on non-par policies issued in the 1960's and earlier. We increased the face amount but not the cash value. We modelled this block of business, and estimated what the profits would be with increased face amount but with reduced lapses. We felt that the improved persistency on the business which would result from increasing the face amount more than paid for the increase in the benefit.

This year we have taken a look at the older par policies and again we are giving an increase in the face amount. Rather than giving a percentage increase in the face amount, we are providing extra insurance equal to the net policy value - that is the cash value minus any policy loan that has been taken out. This is in effect a means of distinguishing whether people have borrowed against their policies or not. We felt we wanted to provide extra benefits to the people who are not borrowing against their policies. We felt that the present system was inequitable between those who did borrow and those who did not borrow. Extra insurance based on the net policy value will achieve this and will again give improved benefits to the older policies. I think that this is probably a first in Canada and it will be very interesting to see what other companies do in this respect.

MR. ASTLEY: Does that apply to all inforce business?

MR. MCLEOD: No, just Canadian policies issued in 1968 and earlier, policies with a 6% policy loan rate or less.

MR. STEPHEN R. HAIST: Is that not simply a backward means of getting around a dividend class where the policyholders have

selected a certain dividend option? Normally you would reward them with that dividend option and you are stuck with a policy loan class whether that person has selected a policy loan or not. You are more or less doing an end-run around this normal dividend classification.

MR. MCLEOD: Our feeling was that people who were not borrowing against their older policies were being penalized by those who did borrow. We thought this was unfair and unjustifiable and wanted to provide a benefit to those who did not borrow. I think that the end result is justifiable and that it results in greater equity between policyholders than the present system.

MR. ASTLEY: I could relate a comment that I think is relevant to that point, Charles. Earlier this year Mutual Life approached the Federal Superintendent of Insurance asking for permission to make direct recognition in our dividend scales for policies in the 6% loan class. In other words, to vary the dividend by the extent of loan utilization. In a sense this was a courtesy call in that the Federal Superintendent probably does not have jurisdiction to say yea or nay conclusively, but nevertheless the message we received was effectively "over my dead body", so we did not proceed with it.

MR. STEVEN: Charles, is this a unilateral action?

MR. MCLEOD: Yes.

MR. STEVEN: We have also been looking at our participating policies. Perhaps we have a statement in our contract form that is different than yours. Ours says that surplus is apportioned by the company and distributed in the form of a dividend. Some of our people feel that that does not give us the right to dictate how the client will spend that dividend. We have the opportunity to distribute surplus in one form and one form only. Do you have the same wording in your contract?

MR. MCLEOD: I do not know.

MR. STEVEN: Is there a lawyer on the board?

MR. MCLEOD: I am not personally closely linked to the negotiations. It was checked out by legal counsel before we went ahead with the programs. I assume that was considered.

MR. STEVEN: Once you have granted that extra insurance, what happens if the client then maximum loans the contract? Is he given the fifth dividend option insurance?

MR. MCLEOD: We define policy loan as the loan at some point before the point of death. In other words, if someone repays his loan on his death bed, that would not be taken into account. The extra insurance is for a period of five years only. It is not a permanent addition to the policy.

MR. STEVEN: Does the insurance amount vary on a particular contract?

MR. MCLEOD: Yes. At the date of death it could be higher or lower than the current net policy value depending on what has happened to the cash value and the policy loan between now and the date of death.

MR. MAURICE GERMAIN: We checked with our lawyer. Our terminology is a little different from yours, but our lawyers said we could do it if we wanted to provide an increased amount of insurance against the people who have borrowed at 6%.

MR. MCLEOD: But you were quite prepared to discriminate against the people who have not borrowed?

MR. GERMAIN: No. I do not see in what sense this would discriminate against them. We are giving them exactly the same thing as all those who were in the same category.

MR. MCLEOD: Would you write letters to them? Remind them that they can and should borrow at 6%?

MR. GERMAIN: I think you can always say to a person who is borrowing at 6% that that is the rate at which you are investing his money, and that is the return he will receive.

MR. MCINTOSH: In our old dividend series with 6% policy loans we actually have two series - registered policies and unregistered policies. I think a lot of companies have done this. Those who have registered policies cannot borrow and as a result they get a higher dividend . It struck me that perhaps we should write to those who have not registered the policies and who do not have policy loans and suggest that they would like to register their policy and get a higher dividend. Wiser heads prevailed, so we did not do that. I had a second thought which we also have not pursued. That idea was to write to those who have not borrowed, and suggest to them that if they were not planning to borrow, we would give them a new policy loan clause which would be the same as our current policy loan clause. We could then give them the higher dividend rate. I still think that would be a good thing to do, but I have not been able to persuade others because of the confusion that would arise. I think that is a way around the inequitable situation that is occurring at the present time.

MR. MCELVAINE: I think perhaps some of these 6% loan clause problems are generating a lot of interest, a lot of concern, a lot of attention. We at one point were investigating the possibility of actually going through a wholesale replacement of our own, initiating a policy change program which would be optional to the policyholder. An old policy would be traded for a current policy on an equal date, cash value equivalent program. This would lead to something of the order of a 25 to 35% increase in sum assured, and perhaps something on the order of a 6 to 8% increase in premium. I still think that there is some merit in offering a program of that nature on an optional basis so that an

individual can make a choice as to whether or not he wants to retain his old policy with the old benefit or get a current policy without the 6% loan clause. However, we are looking at it from the point-of-view of a stock corporation that if we are going to give something away, then there would be some motivation to the company. We would require the increased premium income as well in order to divest ourselves of the 6% loan liability. In fact we were very much on the point of announcing a program of this nature when a company represented on the panel made their announcement of an enhancement. In view of the fact that our program was going to ask the policyholder to pay a little more premium, it would not likely have been well received compared to the program of offering additional insurance without paying premiums. But I think it is something which might well be dusted off the shelf and looked at again.

MR. HAIST: Charles, why in your non-par enhancement did you not attack the policy loans? It seems to me that in that situation you were not dealing with a class of policyholders, but each policyholder individually. It seems to be more obvious.

MR. MCLEOD: Because we did not think of it at the time, I am afraid.

I would like to make a comment on Universal Life. I have been wrestling in my own mind as to what is going to happen to Universal Life in Canada. I see two scenarios. One is a repetition of what happened with non-smoker term. A year ago I think hardly any companies in Canada had non-smokers term, but within six months almost every company brought it in. It was a sudden change - I think the speed of it took everyone by surprise - and something like that could happen in Canada, with respect to Universal Life. There is no traditional Universal Life being offered in Canada right now - I think it could suddenly change in the next year. The other possibility is a tendency toward more unbundling than exists under the contracts in the States. This may result in a higher rate of return as well. Have we already reached this point of complete unbundling? Are we going to bypass the Universal Life or is it still coming in the future?

MS. NONIEWICZ: I think it is coming to Canada because a few months ago one small Canadian company started selling a product in which the consumer pays a single premium and from the return on the single premium that is invested by the company, term insurance is being purchased. So it is a very close relative to the typical Universal Life product.

MR. MOONEY: I believe there are two Universal Life type products in Canada at the moment. In answering Charles' question, I do not think we have gone beyond the point of Universal Life. With unbundling, something similar to Universal Life can be accomplished but it is very cumbersome to manage the pieces. A lot of the attractiveness of Universal Life is that it is computer oriented and that is the way in which it is going to increase the

productivity on the distribution side. It is going to be quite a lot easier and faster to make sales and to keep a client's program up-to-date. I am not sure that it will spread like wildfire across Canada as non-smokers did, but I think we are going to at least see a fairly steady trend towards that product. One thing that was really impressive about the spread of non-smokers' products was that when the Field Force saw somebody else had it, they came in and said they had to have it right away. In some cases this was only days or weeks or months after the same people had said: "No, we think it is a gimmick, we do not want it, there are lower commissions on the non-smoker premiums, there would be hassles with the smokers". When the Field Force started demanding it, companies moved.

MR. MCINTOSH: I used to hear from the Field Force quite regularly as to what they needed, but I do not hear from them any more. They just stopped sending us the business and now send it somewhere else. I think that is how we get the demand now.

MR. ROBERT BLANE: National Life has taken some steps towards the Universal Life type of policy.

Because of systems constraints we have not departed far from the typical Ordinary Life Non-Participating plan and our new plan arose from a re-examination of that plan.

We had commission rates at the 30% level on amounts of insurance of $100,000 or more and wanted to increase them to the 50% level. We also wished to give the policyowners some kind of new money return.

We finished up making an Ordinary Life Non-Par presentation of a Universal Life type of product providing for commissions at the 50% level. This avoids "unbundling". It bothered me to hear the common thread from the panel members' presentations that "unbundling" is where we will finish up.

Under our product:

(1) A fixed premium is guaranteed at the Ordinary Life Non-Par level.

(2) The Sum Insured is completely guaranteed.

(3) Cash Values build up starting in the 3rd policy year. The Cash Values are built up following the traditional formula under which you take the Cash Value at the beginning of the year, add the net premium, deduct an insurance cost for the sum at risk and add interest.

(4) At the beginning of the policy year we declare the rate of interest that will apply in the Cash Value calculation for that year.

A very attractive presentation is made when figures are presented assuming interest rates of 5%, 10% and 12½% (or current interest rate if lower than 12½%). The 5% figures reproduce an Ordinary Life Non-Participating plan.

I hope that we will see more of this type of development than the "unbundling" which the panelists talked about.