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POLICY LOANS

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The following material is a collection of impromptu questions and comments resulting from an Open Forum session on policy loans. The purpose of this session is to discuss cash flow problems, equity between borrowers and nonborrowers, and equity among groups of policyowners having different contractual loan rates. The variable loan rate proposal and direct recognition are also covered.

MR. DALE GUSTAFSON: The second largest block of in force business that my company, The Northwestern Mutual, has can be identified as policies that have a 5% loan interest rate and a 4% reserve rate. On the portfolio of assets exclusive of policy loans identified with this block of business, we are earning something like 8% after taxes and expenses. On the portion of the assets of that block of business that are out in policy loans, we are earning 4% after taxes and expenses, and this block is approximately 50% borrowed. Our dividend interest rate is 6%. Thus, the nonborrower contributes 8% and we pay him 6%. The borrower contributes 4% and we pay him 6%. The figures quoted are only approximately correct and are used to illustrate this serious problem we will be talking about along with other related characteristics.

I would like to start by plunging right into the middle and ask the panel a few questions (the panel does not know what I am going to ask either, by the way) and they may refuse to answer my questions.

I would like Harry to start off by giving us a summary update on the market loan rate legislation.

MR. HARRY HOHN: We are talking about the NAIC Model for market loan rate legislation and as of my telephone call this morning to my office, it goes something like this. The NAIC Model has been adopted in fifteen states. Also, California has basically adopted legislation which has given us a great leeway insofar as policy loan interest rates are concerned, so I consider there to be a total of sixteen states that have allowed you to use most of the NAIC Model. In addition to those sixteen states, we are very optimistic that we will get Ohio and Wisconsin which would bring the total as of this year-end to eighteen. One state, Nevada, has adopted the NAIC Model by regulation, and therefore our expectation is nineteen states at year-end. Looking ahead insofar as 1982 is concerned, our expectation is that fairly early in the year, I guess by July, we would hope to have thirteen more states and that is a high expectation and reasonable expectation for six more. By the end of 1982, if our schedule is reasonable, that's thirty-eight states.

*Mr. Hohn, not a member of the Society, is Senior Vice President and General Counsel of New York Life.

Two things need to be mentioned about the states that have adopted the NAIC Model. Arkansas, even though it has adopted the NAIC Model, only allows you to go to 10%. That is a general limitation in the state constitution which has been held to be consitutional recently by the Supreme Court of the United States. I guess it will be the law for some while in Arkansas. In Texas, it is an NAIC Model but with a cap of 15%. I am not going through a list of the other states because I think that someone in each of your companies must know what those states basically are. For the New York Life, if we are correct on those thirty-eight states by the end of 1982, the territory where about 88% of our new business is written will be covered. So, it gives you a pretty good idea that a lot of the states we are waiting for in 1983 and later are some of the smaller states. That is basically an update as to what we think it is right now.

MR. GUSTAFSON: Harry, just in case there is somebody that is not familiar with this as you and I are, give a three or four sentence summary of what the company is permitted to do under the NAIC Model.

MR. HOHN: Simply, the NAIC Model does two things. Permits you to continue with an 8% fixed rate. Say it another way: If your going to go fixed, the maximum rate under the NAIC Model is 8%. Alternatively, you can go variable and the fixed 8% rate or variable option election can be made between different issues of policies. A company does not have to go one way or another for all of its policies; it can have distinctions between fixed and variable if they think that is a good idea to do. If you go variable, there are certain limitations. You have all heard of the Moody's Seasoned Bond Index; that is the maximum rate that can be charged by a company under the variable.

The important thing is that the variable allows you to change the interest rate on all loans, including all outstanding loans on policies issued, of course, since the legislation was adopted. By the way, the Moody's for the month of September was 16.18%. That would be the rate that you could first use in December of 1981 since the NAIC Model provides for a two month lag. You take the September rate and you cannot apply it for two months. If you do adopt the variable, you have to look at the rate that you are charging on all policy loans at least once annually and if the rate has gone down more than one-half of one percent, you must go to the lower rate. If the rate in the Moody's Index is at least one-half percent higher than you are charging, you can go up. The important thing that we have said before legislatures and before agent associations is, that is the maximum. We do not know whether or not companies are going to go to the maximum. You can change the rate as frequently as quarterly, if your computers can handle that. I think those are the main basic points that are in the NAIC Model.

MR. GUSTAFSON: We are assuming a basic understanding of the history in the United States. For those not familiar with the history, I will summarize for them in two or three sentences. Prior to about the turn of the century, the companies in the United States were charging whatever they wanted on their policy loans. Then with the Armstrong Investigation, and the legislation that came out of that, policy loan provisions were required and a fixed interest rate something like 6% became virtually uniform. The rate was dropped to 5% or lower back in the 30's. The maximum went back up to 6% in the early 60's and then to 8% in recent years and now the new market loan rate.

MR. GUSTAFSON: Kit, would you give us a little summary of what the background, history and current status of the policy loan legislation and opportunities are in Canada.

MR. CHRISTOPHER MOORE: Thank you, Dale. Prior to September 1968, the situation in Canada was very similar to the situation that Dale just outlined in the United States and we still have large blocks of business in force with 5% and 6% policy loan rates defined in the policy itself. Since September 1968, the companies have been permitted to go without a maximum rate in the policy and we had an agreement with the Canadian Superintendent of Insurance that policy loan rates could be specified at the time each policy loan is made. The terms of the loan must include the maximum rate that can be charged. I would like to give you an idea of the kinds of rates that have been charged by Manufacturers Life. Until 1974 we included a maximum of 9% on policy loans and until 1980, 12%, still not sufficiently high rates for the Canadian market place.

During 1980, the industry again approached the Superintendent of Insurance through the Canadian Life Insurance Association in order to get a new agreement concerning policy loan interest rates. So now, provided that the terms of the policy loan are fully disclosed to the policyholder, a company is no longer required to specify a number for its maximum percentage interest rate in the loan agreement. Instead, companies have the option of relating the maximum policy loan interest rate to a multiple of the initial rate charged in the loan (up to 1-1/2 times) or to the prime rate charged by the company's prime banker plus 2% or to a bond index similar to the Moody Index.

These options are available for all new policy loans and for automatic premium loans. Under the new guidelines, Manufacturers Life now uses a variable policy loan rate under which the maximum rate is defined as the greater of 8% or the prime rate plus 2%.

We recently did a survey of the seven largest companies in Canada and we found that five of those companies are using the newer basis and two others are using something more similar to the older style. One has a current loan rate of 18% in the loan agreement and the other company is still using a 12% rate defined in the policy, with a maximum of 15%. For companies that are using the variable basis, their current loan interest rate varied between 15% and 18%, well below the prime rate plus 2% maximum that is allowed under the arrangement. So in Canada there is no question that this new variable loan provision has taken a lot of pressure off companies concerning the problem of direct recognition of policy loan usage in new business. We still have a problem concerning the large blocks of business in force which we'll come back to a little later.

MR. GUSTAFSON: We are going to stick with the market loan rate approach for just a few minutes and then we will get into some of the other things. But, we will remind you of a difference between the U.S. and Canada. Kit will correct me if I am wrong. It is simply that policy loan interest is not tax deductible for the individual in Canada while it is deductible in the U.S. Am I not correct?

MR. MOORE: That is partly correct. We do not have minimum deposit in Canada to speak of. It is not the problem in Canada; it is in the United

States. Policy loan interest is deductible if it can be shown that the money is being used for an investment, a Canadian investment. Therefore, policy loan interest deductibility is still a factor but we do not have minimum deposit.

MR. GUSTAFSON: In effect, for a moment or two, we are going to have a fifth panelist. I am aware of one company that is widely known to be committed to introducing the market loan rate for new business in those states where it can on January 1 of next year and that is Metropolitan. Don Maier of the Metropolitan is in the audience and I would like to ask him to tell us a little bit about what the MET is going to do, and maybe a little bit about why.

MR. DON MAIER: Yes, Metropolitan does plan to go to the adjustable maximum policy loan provision wherever we can effective January 1, 1982, and do the same in any other states as soon thereafter as appropriate regulations or laws are adopted and our endorsement is approved. Harry mentioned that there were a certain number of states that already permit the adjustable maximum loan. For Metropolitan, that would be about a third of our business.

The major reason then that we want to move this way is to insulate us from future runs on policy loans to the extent that we possibly can. Another reason that we think is pretty important is that we want to support any effort to go from state to state to ask the various legislatures and commissioners to adopt the higher adjustable policy loan provision, especially in New York where we are very active in this respect. We think that it will improve our credibility and give us considerable more leverage if we can say that we do move this way just as fast as we can. It is important to us and we feel that it will help our case if we can show live dividend illustrations that reflect a difference in dividends reflecting the adjustable maximum loan provision.

While this is our plan effective the first of the year, we must admit we will not have systems fully in place. That will take maybe another year. Initially we will actually use and show an 8% policy loan rate in all of our material. Anytime an 8% policy loan rate is shown, it will be very heavily disclosed that we intend to raise that rate on the next anniversary up to something reflecting the amount permitted under the new provisions. We will illustrate on the basis that the maximum policy loan provision is in effect in spite of the fact that we will be using the 8%. The mechanical way that we do that is to assume that there was no impact at all on the distributable interest rate of the policy loan provision. Of course, older policies that we will still have with 5%, 6% and 8% loan rates are impacted by the aggregate effect of outstanding policy loans. At Metropolitan, this is not that big a deal right now, because we do not have that much business with large proporations of cash value out on policy loans. We seem to have a somewhat less sophisticated policyholder population and our percentage of outstanding loans is not nearly as great as the 50% that Gus mentioned.

MR. GUSTAFSON: Thank you Don.

MR. MAIER: If there are any questions, I will be glad to try and answer them.

MR. GUSTAFSON: I would like to ask if there is anyone else in the audience whose company is making a similar commitment. Let us just ask you to raise your hand. I see three or four hands. Are you willing to identify who you are and your company so that we can know?

MR. GERALD J. OYEN: Similar to Metropolitan, we are planning to go to the variable loan interest rate January 1, 1982, in the states where we are allowed. We are in the process of submitting the endorsement now to the states and we have our dividend differences worked out pretty well. They are being implemented and tested now. (Mr. Oyen is with Penn Mutual.)

MR. GUSTAFSON: Thank you. Anyone else want to give us a little information. I comment that I am pleased that several companies are giving credibility to the legislative program.

MR. ARNOLD DICKE: I just wanted to ask a question of the people that are doing this. Are you intending to keep alive a series of policies with fixed interest rates for minimum deposit purposes and the like?

MR. GUSTAFSON: Penn Mutual's intention is, in effect, to have two series. Policies will be sold either with a fixed 8% or with the variable loan rate and they will thus remain alive for minimum deposit. Is that the Metropolitan's intention, Don?

MR. MAIER: At the moment, we are going with the adjustable maximum loan rate provisions in all policies. There are some of us who think that it would be a good idea to keep at least one - say our high early cash value policy - with the older rate, and we could still do that, but we haven't made that decision.

MR. BILL RUDD: This is just a question. I am amazed, why is not every company trying to use this new facility? I do not know what the American situation is, but we in Canada have had the variable loan interest rate and could not get along without it.

MR. GUSTAFSON: There will be a couple of us comment directly on your question. I would like to now call on Art Cragoe to tell us a little about what the Franklin Life has done, is doing, and why.

MR. ART CRAGOE: First let me say that as soon as the variable loan rate is effective in enough states so that we will not have duplicate system problems, we will also be changing to variable loan rates. I am sure most companies will. What you are seeing are pioneers who are willing to go in sixteen to thirty states. Other companies are going to wait a little longer until close to all 50 states have variable loan rates.

Gus has asked for us to talk about what we are doing on so called direct recognition. I do not like to use that term because it implies that there is something special. We do not feel it is very unique, or very special. First of all, let me state that policy loans are assets, and what we are really talking about is how to treat policy loan asset portions in the interest return component of a dividend scale.

Now most of us are used to thinking of a single crediting rate in the dividend scale. At Franklin Life, we have been saying to ourselves for some

time that there can be more than one interest rate in a dividend scale. A policy loan is essentially a directed asset. That is, the policyowner has decided where a part of his assets are to be invested. It is as if he came to our company and said, I would rather have you buy me a very safe bond paying 4% or 5% with a portion of my reserve or cash value. Some people are now telling companies to invest a portion of their excess funds in T-Bills. We treat policy loans like T-Bill Life treats T-Bills.

When we developed a plan of changing from a single portfolio based investment return to an investment year method of investment return, one of the things we did was look at all of the characteristics of the yearly change in values to which IYM rates will be applied. This caused us to say that once we are on this investment year method, our crediting rates for investment return could reflect, to some extent, the yearly asset return -- loan and nonloan. We said, yes, we can do that. Our computers allow us to do that nowadays. So, as part of our change to the IYM method, we closed off the old block and are using a portfolio rate on it and no effect of the loan is used on the old block. For newer segments, we use a policy loan related interest rate for the portion of cash value increase offset by the policy loan and we use an IYM interest rate for the balance. Another way of expressing this is to say that we used different interest rates on the loaned and unloaned portions of the policy value increase from the year we changed from a portfolio to an IYM method. Since IYM interest rates are going to change every year, our dividend is now composed of many calculation pieces.

MR. WALTER N. MILLER: A question for Art, two parts. The system that you just described for adjusting dividends on in force policies to reflect policy loan activity is apparently being done without any specific amendment to the policy contract. I would be interested in your comments as to what your lawyers have told you as to the safety of doing something like that. The second thing I wish you would cover is to clarify for us what you are doing on new issues; including whether you have a specific policy provision on new issues that reflects this practice or what.

MR. CRAGOE: Again, this subject broadens from policy loans to dividend philosophy very quickly because the policy loan is the most, I will not say sensitive, but the most obvious place to look at philosophy. But loans is only one component of our dividend formula. We feel that our dividends are under the control of the board of directors and we use a fair and equitable method. Our lawyers say that we are distributing dividends on a contribution basis in proportion to each participating policy's contribution to divisible surplus.

We do not describe in our policies the methods on which we distibute surplus. We did not in the old policies and we do not in the new policies. Really, this is a refinement. We feel that the use of a different interest rate in the dividend formula for each yearly increase in the policy's cash value is really just a refinement in the calculation of excess interest. You could use the infinite number of classes there if you wanted to use some classical thinking. But our dividend will be the same for two policyholders that have the same experience who by their own actions have elected a certain policy, by their own actions have elected a certain face amount and by their own actions have elected a certain investment program with a portion in a policy loan investment.

MR. DICKE: I believe you have received approvals from the states you were trying to get them from except you are not in New York with your parent company. Did I understand from someone that not having this explicitly stated in the policy was actually necessary to get the approval from some of these states?

MR. CRAGOE: We did not. Again, we do not feel that this is a policy provision that needs state approval and we did not go to every state in which we do business and ask, is this a fair and preferable dividend formula. We just do not feel that it is a proper subject for the state regulation to decide dividend formulas.

MR. GUSTAFSON: One or two comments on the subject and then we will go on. John Harding.

MR. JOHN H. HARDING: Mr. Cragoe, what do you do with dividend illustrations on new policies? Do you have any which include any amount of borrowing?

MR. CRAGOE: Yes. Actually on new policies, of course, there are no loans outstanding initially but all of the new policy illustrations and all of our illustrations for existing policies carry a caveat that says, "Participating policyholders who make policy loans or other withdrawals of policy values (and I want to come back to that because it is not just loans) may in the future receive dividends and surplus interest in lesser amounts than policyholders who do not make policy loans or other withdrawals. It is important to maintain maximum value in your plan to received maximum benefits."

For our new dividend scale, it is not just loans considered in individual dividends that are illustrated for the future. We do make a statement in the illustration that we are anticipating no further loans to be made against the policy. What we are saying is that this individual situation is projected to the future of this dividend illustration.

MR. HARDING: What happens whan a projection into the future is made by the company or an agent of a company using some pattern of policy loans in the future?

MR. CRAGOE: You mean, assuming that a borrowing plan is going to be made?

MR. HARDING: Yes.

MR. CRAGOE: I am not sure that we have a lot of company literature in that regard; we are not a minimum deposit company. We do not really encourage a pattern of borrowing and our agents could not do such a thing very conveniently. Although I would say that there are lots of other features in our dividend scale, like a floor of the previous dividend scale. No dividend can go under the floor of the previous scale. So that if a policyholder assumed that a loan was going to prevent any increases in scale in the future, he could go back to a previous scale and use it.

MR. GUSTAFSON: I would like to move on now and ask Kit to tell us something about what I believe is Manufacturer's unique program in this area for

a block of old business.

MR. MOORE: We too have been concerned about the effect that policy loans are having on the equity in our dividend scale, along with all the matters Mr. Reiskytl and Mr. Kraegel outlined in their paper. So, for the next year, in addition to the regular dividend scale improvements that we are putting through, Manufacturers Life has approved an enhancement program for its participating policies. Under this approach, Manufacturers is going to introduce an enhancement of the death benefit for the older block of participating insurance business, primarily prior to 1969. Those are the policies with fixed loan provisions in them. Taking into consideration the direct recognition of the policy loan usage, the enhancement will be on net policy values, which will take into account the maximum amount of policy loan during the preceding six months.

This kind of program will have the advantage of providing the available dollars for additional death benefits to those people who are keeping their policies in force, without giving additional benefits to anyone terminating or replacing, or taking maximum loans on their policies. This kind of approach is a logical one in terms of distribution in a period of improving mortality and improved interest earnings but where the market values of assets are depressed. In doing this, Manufacturers has recognized that policy provisions are no longer appropriate or equitable in terms of today's interest rates. As a result it is just impossible to provide an equitable return in the dividend scale without going to a direct recognition approach for those longer term policyholders who do not choose to borrow on their funds.

Let us hope that this program will restore a degree of equity to the older policies. It will not deal with the problems of business issued since 1969 at this point, but it will accomplish the desired result while at the same time not taking any benefits away from those policyholders who continue to borrow on their policies. Gus, do you want me to talk about what the financial effect might be?

MR. GUSTAFSON: Yes, please.

MR. MOORE: The original proposals assumed that the entire cost of the program would be borne by the earnings of Manufacturers nonparticipating policies. We have nonpar business in Canada and that business has developed large profits during the recent years. Last year, an enhancement was given on nonpar business to reflect that fact and in addition a factor was included in the dividend scale on an across-the-board basis reflecting the unusual nonpar profits. Models were run for the current program being planned and it was shown that the nonpar profits could also bear the cost of this program, amounting to about two million dollars a year. On the other hand, it is interesting to note that it can be shown that with enough improvement in policy loan utilization ratios, the program could pay for itself.

At this point, it is hard to believe that policy loan utilization ratios will ever go down again unless there is an unusual incentive for the policyholder to pay back the loan. I will try to give you an idea what projections to 1995 would look like with a conservative yield spread of about 4% between the policy loan rate of 5% or 6% and the average interest

rate used in calculation. It was shown that if loan utilization rates were going to improve, from their current level of 30%, to 20% (difficult to believe but conceivable) as opposed to worsening to 40%, then with or without this special enhancement program, the program would indeed pay for itself. If we used larger interest rate spreads rather than 4%, then we would not need as much of that 10% drop in loan utilization ratio. We also showed that with the program that is being planned, the increase in rate of return to the policyholder would be enough to discourage policy loans when interest rates were at levels of 10% outside the policy. So it is not going all the way, but it is going quite a long way towards discouraging policy loans. If we just look at the effect that the program will have on life insurance, it is going to end up cutting the cost of the insurance in half to the policyholder.

MR. HOHN: I would like to make a general comment. I agree with everything that has been said here in terms of the contribution concept and how there is not complete equity between borrowers and nonborrowers. I think that you can go back to that very famous case of Rhine vs New York Life which we won. I keep reminding myself that that was a very carefully split decision. I think that everything that has been said here in terms of enhancement programs are all good ways to go.

I am very happy to hear Art say that most companies will eventually be on the variable basis. To the extent we do not have but a few doing it in the next couple of years, those of us who are out on the firing line with the states are going to have a great loss of creditability because we indicated that this is really the only way to go and direct recognition was sort of a halfway house to the solution.

If a company were to adopt a variation on the enhancement program, I, as a lawyer, have to say that one of the key issues in doing that is an upfront disclosure, a very large upfront disclosure, to the policyholder to whom you are selling the policy. Art mentioned that it was in the dividend illustrations. The problem that I see is going backwards. This involves the expectation of the policyholder and the stated rate in the contract. You still have a problem with the stated rate in the contract. The expectation of the policyholder is important. If he sees 8% in the contract and there is nothing more about it and you begin to do the sophisticated calculations that ultimately result in different dividends if there is an outstanding policy loan, that may give you some problems. If the policyholder is alerted that there are going to be these differences, so that the expectation is clearly known at inception and he really knows what is going to happen, that goes a great way to . . . a great long way . . . to keeping yourself out of court.

Again, my main point is that if there is going to be direct recognition, I really cannot advocate strongly enough, that there be some clear delineation of that. If you have people who are doing minimum deposits, maybe you ought to have an illustration which shows exactly how the loans will effect future values.

MR. CRAGOE: Thanks. Let me just say that we, too, called our dividend program an enhancement program. We started it a year ago and we are going to have another one on nonpar called an enhancement program. We did send

all of our participating policyholders a four page explanation, not so much of policy loans but of the whole concept that the dividend scale is changing. It was explained that among those changes are different effects for policies of different size, for borrowing, and for withdrawals of surrender values. I keep coming back to the fact that loans are just another form of assets. Also, if other policy values are withdrawn the excess interest and dividends will change. But, the enhancement concept is good. Harry, I was a little puzzled there when you said policyholder sees 8%. Nobody sees 8% in our dividend scale, they just see a number. We do not talk about the interest rate that is in the dividend scale.

MR. HOHN: No, but you do talk about the interest rate that is in the policy loan provision.

MR. CRAGOE: Oh yes.

MR. HOHN: That is the big number that he is looking at and if he sees 8% and he has two policies, one he borrows on and one he does not borrow on. And if the dividends go up on one and stay the same or go down on one, he is going to ask what is happening. It is the perception of the policyholder created by the agent who is selling this stuff when he says . . . and you got this fixed 8% (or whatever the percentage) loan rate. The policyholder says great and makes a policy loan. Then three years later when his dividends are not "enhanced", he is going to get concerned about it. That policyholder has a legitimate concern and the only way to take a part of that sting away is through disclosure material that alerts him in a very clear way. The agents are not going to like that. So it is a struggle between protecting your company and "It won't sell".

MR. CRAGOE: I agree with you completely that disclosure is very important and has to be, like ours was and is, way up front. I wish I had more confidence in the ability of any of these programs to affect the loans. Maybe if we get the Canadian method that allows us to get a really decent rate, we can have some influence. But we have been on our program a year and I am looking at a report of our new and increased loans for the first nine months of 1980 versus the first nine months of 1981, and there is no change. We did not get any more repayment.

As I said, we have a feature in our dividend scale that any loan made prior to the beginning of the IYM method is not held against the policyholder. It does not affect the actual dividend because we are only using new loan transactions since the change to the IYM method. On the other hand, a repayment of any old loan is new money to us and his dividend could be greater. We give the greatest dividend of all to a policyholder who had a loan prior to October 1, 1979, and repays it now. But it has not resulted in any significant repayment. Our repayments are less in the first nine months of this year than they were for the first nine months of the previous year.

I am really not too sanguine about direct recognition as a real loan control purpose. I am more interested in it as a fair and equitable way to protect the company. On the nonpar side, we are going to try to do the same thing starting January 1, 1982. We are going to give extra death benefits on our older nonpar policies. There will be a recognition of the portion of policy that is loaned. A nonpar policyholder of ours who dies

with a fully loaned policy will get his face amount. A nonpar policyholder who does not have a fully loaned policy will get an increase in his death benefit. One-half per cent per year in force.

MR. MOORE: I just had some good news and bad news concerning the effect that this is going to have on the policy loan ratios. When we did our survey of the seven companies, we looked at loan utilization ratios at the end of 1980 split between policies issued before September 1968 and ones issued after 1968. For the relatively small policies issued before September 1968, which had a total loanable value of $3.6 billion, the total loan utilization ratio for the seven companies was 23-1/2%. That figure compared to a loan utilization ratio of 14-1/2% on the one and one-half billion dollars of loanable values for policies issued after that point. Now that is not going quite as far as the fully variable loan either, that was simply a high maximum. So there was some good news there. During the first six months of 1981, the fixed loan rates went up by 2-1/2% and the others only went up by 1%. But the bad news is that after twelve years of these policies being issued at the higher maximum loan rate, we have only 30% of the total loanable values on that new basis. So there is quite a time lag between the time you change to the basis and the time you receive any effect.

MR. HAROLD CHERRY: Since I am a pessimist, I would like to add to your bad news a little bit. As I understood it, you were comparing two blocks of issues, roughly prior to 1969 with 1969 and subsequent, and a loan utilization ratio of the more recent one being only 14%. We have found, as most companies have found, that policy loan utilization varies by policy year or duration and is much lighter in the early policy years and I am afraid that is largely what those statistics reflect.

MR. GUSTAFSON: We have heard from two of our panelists, Art and Kit, whose companies in some fashion or other have installed or are installing programs that apply to in force business. Is there anyone in the audience whose company or who knows of a company that is considering or has done a similar program?

MR. ROBIN LECKIE: I just want to make a couple of general comments, if I may. First of all, to correct any incorrect impression you may have received from Kit, we are not putting this program into the United States. I would very much like to, but I am a little leery of some of the comments from the legal counsel here and it has to be tested out first.

Secondly, it is only on new business, not on old business, where we have the variable loan rate and we have adequate equity. But as Chief Actuary at Manufacturers Life, I have a great concern about the equitable return on our old policies. And I think that the Chief Actuaries of all of these companies here ought to be concerned about the return that you are providing to policyholders who entered into an insurance contract with your company, with the expectation that you would be doing a reasonable job for them. Now at the time that they took the contract, policy loan rates were reasonably equivalent to portfolio rates or above. I certainly concur with the concepts of Mr. Cragoe that policy loans ought never to have been included in the determination of the portfolio rate. I am not sure, as a matter of fact, whether that ever was intended. I have not researched that. But, policy loans are in a sense a segregated fund or separate

account in which the policyholder has made a choice of an investment and he has got a reasonable return. He has received what he has paid for and it would seem to me that the portfolio rate ought to be formulated from the general funds of the company.

In any case, the concern should be for the equity of those old policyholders who are not borrowing and who now have a choice of moving off to a universal life type policy. Such a move would be a disastrous mistake on their behalf and we should do something to protect them or to move off into replacing it with some other new form of policy in which the terms are more reasonable while reflecting today's circumstances. It requires us to take a look at what we are doing. For us, we felt at least we can provide insurance on their savings. We are in effect insuring their savings. We do not define the policy loan as savings though. We define that as something they have taken home with them, not left as savings with us. But if those funds are left as savings with us, we are prepared to insure them and this is not uncommon. Credit unions do this and banks many times if you leave a savings will double the money on death. In effect, that is what our enhancement program in Canada is intended to achieve. We are not going all the way in restoring equity for older policies, but the program certainly does advance their return and is more in line with what they must have felt they were entitled to when they purchased the policy. I do not believe that they ever felt they had to take a policy loan in order to get value from their contract.

MR. GUSTAFSON: Thank you. When I asked the question, are there any other companies that have done something of this nature with their in force business, there were several subtle voices saying, "What about your company?". I guess it is time for me then to tell you where we are, where we have been and where we are going.

Northwestern Mutual has gone back to its old policyholders twice in recent years. In states representing a very significant portion of our business, we have offered each policyholder the opportunity to amend the policy loan provision on contracts from 5% or 6% to 8%. Of those policyholders who have received such an offer, 34% have accepted and have amended their contract to an 8% provision. We have not done it in all states because we did not receive approval of the amendment program in all states quickly. We now have approval in all but one or two but we have been busy with other things and have not completed a formal amendment program.

One of the things we have been busy with is what we have called in public, our "Get more out of life program", and inside we have called it UPDATE. It had nothing to do directly or indirectly with the policy loan provision, so I did not think of it in this context, but we have offered all of our in force policyholders the opportunity to amend the reserve interest rate from whatever it was to 4%. There was an increase in the face amount of protection and improved federal income tax performance with a higher reserve interest rate, thus the policyholder's value was enhanced. One way is directly through an increase in face amount and another way is through a more efficient dividend analysis. This program was universal to all policyholders in all states and approximately two thirds, 66 and a fraction percent, accepted the opportunity to update.

Now those are the things that we have done in the past and you see neither

of them directly or indirectly related to what we have been specifically talking about here. Now, for the future, we have been committed for several years to a complete new policy series for January 1, 1982, and like most companies, we redo the whole thing every 4 or 5 or 6 years. That has been on schedule and we will be introducing a new policy series with perhaps more dramatic changes than many of our policy series changes in the past. We have wrestled and struggled mightily with what to do with the policy loan provision on January 1, 1982. First, we did not expect the NAIC legislative program to move very rapidly or successfully. We have been very pleasantly surprised and pleased with the aggressive coordinated legislative program that is going on with formal support from the NALU and active support from the companies.

We could not realistically expect to have the market loan rate available in states representing more than about 35% or 40% of our territory by January 1, 1982. When we examined closely the immediate marketing capabilities and attributes of that kind of a split introduction, we did not like it. I agree with what Art has said about direct recognition. It may be a way station on the way to a market loan rate. Nevertheless, we are implementing a form of direct recognition for new business of January 1, 1982.

At the same time, we have made a major internal committment to another amendment program of some kind. We have not yet pinned down the details of what we are going to offer old policyholders, but we are committed to the development of a more tax effective, more loan effective and more value effective contract which we will be prepared to offer all in force permanent life insurance policyholders by January 1, 1983. Plus, we have a rather complex approach to these issues. Our decision to introduce direct recognition for new business on January 1, 1982 does not represent a decision that we prefer that to the market loan rate approach nor does it mean that we have abandoned the market loan rate. We will have to evaluate that during the following months. These are our intended actions which are directly germane to the subject of this panel, so I felt it was appropriate to outline where we are.

Brief mention was made of Universal Life and it is a uniform characteristic of the Universal Life contracts to use direct recognition of the impact of the policy loan. They do, in effect, exactly what Robin Leckie described. They say that a policy loan is not a part of the invested assets behind your contract. There are a variety of practices, but each of the Universal Life contracts contains that feature. Any other comments from panelists on the general subject?

MR. CRAGOE: When we get to the variable loan rate, it is quite like under the scheme of recognition that we are using for all parts of policy values, that the dividends might be higher on a loaned policy. This is possible because if we can get 10% on the policy loan and the portfolio that is being credited to the rest of the policy values is at 8%, he will get a better dividend if he borrows. Now we may not credit the entire policy loan rate because again, we have taxes and expenses. But, direct recognition is not just a one way street to the detriment of the policyholder. It's time has come, because as Robin said, policy loan rates are so much different from portfolio rates.

MR. HOHN: I would just like to make a further comment on what Art just said. Walter Miller is here so I can speak freely because he is going to back me up or correct me. In doing a lot of work with the California association to get the NAIC Model adopted in California or at least get a law to go through which would allow us to use variable, we ran into a lot of agents who were raising the question about the variable rate being the death of minimum deposit. We find a lot of minimum deposit people in California. We began doing a lot of work to determine what happens in various circumstances when you do adopt the variable rate in conjunction with minimum deposit.

I was kind of amazed that if the interest rates go high enough, when you have a full NAIC Model and you are doing a full variable, the thing can almost turn into a money tree. As the interest rate goes up and up and up, you are, as a high bracket taxpayer deducting the high rates of interest, at 50% or higher marginal tax rates. It is higher in California because of the states taxes. You are deducting all of that interest and you are getting these wonderful dividends back which are nontaxable. So, as the rates go up - I do not know what the rates are going to do - but all of a sudden a policyowner could find himself in a serendipity situation.

Now, Walter, I realize I have oversimplified it, but basically that is where we came down. The point that I am trying to make is that we ran into a lot of agents across the country who kept saying if you go variable, you are going to kill minimum deposit and the whole thing is going to fall apart. As you mentioned here, if you are going to go variable, there is always the option of having two policies. The high cash value policy would have the fixed loan rate and the other policies would have the variable loan rate. But we found that agents quieted down and they began looking at the market feasibility of variable when we began to make illustrations using high interest rates.

MR. MILLER: Three quick things. The first is to provide an actuarial certification for everything Harry just said. I am happy to do that.

MR. HOHN: Thank you.

MR. MILLER: Second, one other bit of background on the situation that Harry and his cohorts on the ACLI Task Force spearheading this legislation found. When they were trying to get agents' support for the variable loan legislation, they found it is not easy . . . it may in fact be impossible to get it passed in the state if there is active agent opposition. Let's face it, it was not just minimum deposit in general that the concerned agents were trying to preserve, protect or save. It was focused on one very specific thing. If we adopt this variable provision, are we still going to be able to offer minimum deposit illustrations that beat term? As Harry indicated, we ran some scenarios which suggested that would be the case.

One more thing, coming back to the point Art Cragoe just made, which is that if you combine a direct recognition approach with a full investment year approach, the cheapest possible cost of insurance might be realized by a policyholder who borrows fully. Art, supposing a company adopts a program and a system like that and gets into such a situation. Do you think there would be any obligation on the company's part to inform its

policyholders that the best way to make the best use of the marvelous insurance policy they have bought is to borrow as much as they can? I suspect that concept would not be immediately grasped by most of the policyholders.

MR. CRAGOE: No. That is a leading, tricky question if ever I heard one. I am not so sure that cost or a projected cost at any one point in time is the basis for making a commitment as deep as borrowing the entire value of a policy. Remember, the IYM method goes up and down. When repayments of loan occur, they are going to be treated as new money in the year that they come back and hopefully full borrowing is not going to be the permanent position of a policyholder. Again, I am no minimum deposit expert because we do not sell minimum deposit. So, perhaps I can get a little assistance.

MR. GARY M. DONALDSON: This does not concern minimum deposit, but it is an example of an amendment program that we undertook. In 1980, Aid Association for Lutherans offered deferred annuity owners the opportunity to obtain a higher current total interest rate in exchange for removal of their 6% loan provision. This provision is replaced with a partial withdrawal provision that is common to annuities now used.

We are pleased with the success of this program. Over 21,000 TSA and non-qualified annuity owners were contacted and 85% accepted the offer.

Amendment forms were filed in all states for approval. Generally, AAL received state approval without difficulty. However, New York and Pennsylvania required much correspondence before their approvals were gained earlier this year.

We review annuity pricing every calendar quarter and revise it when necessary. Lately, that's every quarter. This pricing review includes adjustments made for the percentage of cash value in loans for owners who chose not to accept the amendment. Those percentages are currently 10% for TSA, 24% for annual premium nonqualified and 52% for single premium nonqualified.

A revised current total interest rate is communicated to owners each quarter. We use that opportunity to remind them that a higher rate is available if they do not wish to keep the benefit of their loan provision. Over time, this will tend to reduce that group to only those who are using their loan privilege.

MR. GUSTAFSON: Thank you. That is very interesting. I might add that this type program is applicable to annuities since a loan provision is not required in the contract. A loan provision is required in a permanent life insurance contract.

MR. THOMAS SUTTON: I wanted to comment on the comparisons that were used at the CALU meeting and also used at the MDRT meeting. There were about 20 different scenarios. The ones that looked better under minimum deposit basis than current fixed 8% interest rate really depended on either having a new money approach on the nonloaned assets or a very high assumed rate of utilization of loans and in both cases, the Federal Income Tax levels assumed were relatively favorable. One of the possibilities, if you are

pessimistic, is that the companies that jump into this on January 1, 1982 and bring out new dividend scales and policies might impede the progress of the legislation if, in fact, the basis of their policies is not as sufficiently favorable as has been presented to some of these agents. Would you like to comment on that one?

MR. GUSTAFSON: Indirectly, the comment that I want to make is germane to that. One word that has been often used when discussions of equity take place is subsidy. At least we use it a lot. With the traditional portfolio or new money determination of dividend interest rates that do not reflect the policy borrowing, there is a subsidy of the borrower by the nonborrower if the nonloaned portfolio interest is higher than the company's net return on the loan portfolio. Thus, for any company that is currently using an 8% policy loan interest rate and their dividend interest rate is higher than the company's net after expenses and taxes return on an 8% loan, then there is a subsidy of the borrower. The market loan rate approach or a direct recognition approach effectively eliminates that subsidy.

During a transition period, any company that is willing to continue to subsidize the borrower may well have superior looking minimum deposit plan borrowing ledgers. Maybe they are entering a world where in order to maintain that relationship, they are committed to finding a number of policyholders who will not borrow, thereby maintaining the subsidy. That is a short term transition problem with which we will all have to deal.

The gentleman from AAL triggered another thought and gets me down towards the bottom of my page which is just as well, considering the time. We have here been considering two general approaches, market loan rate and direct recognition. There is a third approach, the AAL approach which can be used in annuity contracts.

Well, I just commented that you cannot use the third approach for permanent life insurance. It is true that policy loan provision is not required in a Level Premium Level Benefit Term Insurance contract. There are two companies, one already in the market and another one coming on January 1, 1982 that offer a participating Level Premium Level Benefit Term to Age 65 contract, on which the dividends are used to purchase paid-up deferred additions. The contract does not have a policy loan provision. The company that is already in the market place is Union Central and they call their term or their contract, Ultimate Term. The company that I know of that is introducing a somewhat similar product January 1, 1982 is Northwestern Mutual. As you might know if you know anything about our history, we are going to name our contract, Extraordinary Term.

We have great hopes for this contract and I would remind you, as I have to remind everybody when we talk about it, people historically have not used the policy loan provision for borrowing. They could get a better deal at the bank and so, typically, in the past, prior to the mid 60's, policy borrowing was usually done using the contract as collateral for a signature loan from the bank. That will be true with this sort of contract as well. It does have cash values and they are prime security for a market interest rate loan from a lending institution. Both Union Central and NML expect great things from this product.

But, it is in this context that a third approach which has admittedly some

limits, is available. Is there anyone else who knows of a different approach? Or, wants to ask a question on any aspects of this? Norm just raised his hand.

MR. NORMAN PEACOR: An observation and a question. To you, Dale, on the subject of the direct recognition. I wrote a paper on this some ten years ago having to do with charging simply 1% more than policy loan interest rate. When Wilfred Kraegel and Jim Reiskytl wrote their paper, they acknowledged that and also pointed out the severe deficiency in that approach. That is to say, it would not prevent disintermediation. The lower the interest rate, the more attractive it would become for that to be a prime source of borrowing. It may be easier than going to the bank or something of that nature. I would suggest that all you have done is raise the threshold of pain by going to 8% instead of 4-1/2% or 5%. If interest rates persist in staying high, you will have created an alternative and desirable form of interim borrowing until you move to a variable policy loan interest rate.

The second thing is that I would like to make an observation as to why everyone is not joining the bandwagon on the variable policy loan interest rate, and that is the question as to what is the tax rate that you are going to apply to those policies that are borrowing. For example, Harry, you mentioned 16.18% as the Moody's rate, which is more than 10% above the average rate of interest that companies now are even able to have. Any company which went to that rate and has a marginal tax bracket in excess of 100% and attributes the proper taxes to the high policy loans, may actually decrease the dividend substantially. There are some real problems until and unless the federal income tax laws get revised. Art, this is in contrast to your comments.

MR. CRAGOE: Your comments are in regard to Phase I companies. My comments are in regard to my company and we are not in Phase I.

MR. GUSTAFSON: Several comments have been made throughout this discussion to the effect that direct recognition is a half-way stage or part-way towards the market loan rate. Also, Norm's direct remarks and other earlier remarks point towards what that means and I will try to make it explicit and see if anyone agrees with it. We have two powerful concerns. One is equity and we have discussed that pretty thoroughly, and the other is disintermediation (runs on the bank during the successive credit crunches) when the interest rates go up to peak and come down. Now we are in a situation where the interest rates went up and seem to stay up.

Direct recognition, because it typically is based on maintenance of a fixed policy loan interest rate of 8%, is virtually no help in stemming the increase in policy borrowing that seems to accompany the swings in interest rates. The market loan rate, restricted as it is in the NAIC Model, will be a much more effective deterrent to these massive increases in borrowing. That is the principal argument for seeing the market loan rate as being a better long term solution.

MR. CRAGOE: Dale, do you think you can offer the market loan rate as part of an exchange practice and thus, get it to your old policyholders so you do not have to wait for another 20 years for the values to build up on your new issues?

MR. GUSTAFSON: There are complex series of discussions and arguments. One, we rather substantially share Art's company's view that it would be sound from a distribution point of view and reasonably safe from a legal point of view to unilaterally impose a form of direct recognition on old policyholders. We are equally sure that we could not unilaterally impose a market loan rate provision, and thus a part of our frustration is that we want to find a way to help immunize the company against these severe demands, but haven't yet figured out the best way. Our concern is for the potential of a serious credit crunch in the next 3 or 4 years. So all of these things are mixed together. Any other question or comment?

MR. ALAN EMMER: Mr. Cragoe mentioned that his direct recognition is in conjunction with the IYM method. I would like to ask him if he feels the IYM method necessary to have direct recognition?

MR. CRAGOE: I am not sure. I merely said it was much more convenient to work it into the calculations because it is just part of another policy value change component since we have a family of interest rates for crediting on various pieces of policy value increase. Policy loans are just a good place to start.

You know, next year it may be directed assets of some other kind. The policyholder may direct us to put some of his money into T-Bills for them and the dividend scale may reflect the portion that the policyholder has directed up to put into T-Bills for him. It is easier to do with IYM.

MR. EMMER: Is it a legal requirement to use IYM to have direct recognition?

MR. CRAGOE: I would not think so but I am not a lawyer.

MR. GUSTAFSON: We certainly do not take that view at Northwestern. Whether it is for new business alone or for old business, we do not believe that there is any necessary relationship between IYM and direct recognition.

MR. CHARLES MCLEOD: A question to Mr. Gustafson. When you went to existing policyholders and, in effect, said: "Your policy has a 5% or 6% policy loan rate, how would you like to move to a policy which has an 8% policy loan rate," were you, or are you concerned that this alerted many policyholders to the fact that they had a source of cheap funds in their policy with the result that the loan utilization went up even more?

MR. GUSTAFSON: We were very very concerned about that, but there did not seem to be a significant jump in borrowing that could be related to the program. So we were a little bit relieved that it did not trigger as much response as we expected.

MR. MCLEOD: Thank you.

MR. GUSTAFSON: Well, the point is that loan utilization has been steadily going up as interest rates have gone up and there was not an extra blip to coincide with the amendment program. Jim Reiskytl is in the audience and can correct any error in the following statitics. Our 5% loan business is currently 55% borrowed and that has been going up something on the order

of 5% to 7% a year since we first started to keep track.

MR. JAMES REISKYTL: I would like to follow up on Tom Sutton's comment and perhaps ask Arnold, or Don, with the market loan rate, how often they plan to change their illustrations? It seems to me that they may be caught in somewhat of a Hobson's choice. Tom said that you have to use high loan utilization or IYM to make the policies attractive for minimum deposit. If you choose to make it attractive, it would appear that you would have the fluctuations associated with IYM in either case. Without IYM, and with high utilization, the market loan rate could put you in a position that today with a 16% loan rate your dividend illustrations for this block of business are very attractive. Then if the market loan rate a year from now is 12% you have to slash the illustrations. How do you plan to deal with these fluctuations, possibly quarterly, in the market place?

MR. DICKE: We are not intending to use the highest rate allowed initially. We are trying to choose a rate at a level we think we can hold on to for a period of time. Actually we are planning to change the scale in about a year anyway, so we have a year to play with this to see what will happen. We are also not planning to encourage minimum deposit with the variable loan policy. However, it could very well turn out to be a very good deal for high tax bracket policyholders. If it happens, it happens.

MR. GUSTAFSON: Several of you have commented that your companies do not encourage or are not involved in minimum deposit. The Northwestern Mutual has never encouraged minimum deposit. We have steadfastly refused to provide any tools for the agents in this area, but it hardly even slowed them down. They have many sources of ready access to Northwestern Mutual dividend illustrations prepared on somebody else's computer. I wonder if maybe some of you are having the same thing happen and do not even know it.

MR. DICKE: Perhaps I should clarify. I could not possibly claim for Penn Mutual the distinction of being hard on minimum deposit approaches. Actually, we are planning to have a series of lower loan interest rate policies that we expect to use for minimum deposit in many cases. That is what we expect to have happen, but in some tax brackets we may be surprised when the agents see the figures in illustration.

MR. MAIER: As I mentioned earlier, we are going to use a dividend illustration basis for the new maximum adjustable loan provision assuming no loans. There will be no impact of loans since we would anticipate that we would use an interest rate which will be somewhat near what we would earn otherwise. We do illustrate minimum deposit situations if requested and for those we are using a significantly higher rate than the 8% we will initially be charging. I must admit I do not know right now what that higher rate will be, but it is a rate that is somewhat illustrative of what we might be charging on policy loans under this new provision.

MR. GUSTAFSON: Any other comments or questions? Any from the panel? Anything we left out or uncovered?

MR. MOORE: There is one interesting point and perhaps we will discuss it in the workshop this afternoon. Walter Miller brought up the point in connection with Art's new approach of whether or not we should be

recommending to policyholders to take out policy loans, in their best interest. That is a difficult question to wrestle with. I have thought about this myself in terms of our existing situation. What would happen if we were to get into the situation where all policyholders were acting in their best interest?

We looked at the numbers last year and we found that if we just looked at the difference between the policy loan interst rate and the average money interest rate that was available in the market place, we came up with a loss in earnings to the company of thirty-five million dollars for that one year. When we looked at new money rates and treated the loans as demand deposits, which they really are, we came up with an annual figure of sixty-five million dollars, nearly one year's statutory earnings for Manufacturers Life. Certainly, if that happened to a company the effect could be mitigated to some extent by dividend scale changes. On the other hand, it is difficult to substantially reduce a dividend scale in times of rapidly increasing interest rates. It is a problem that we sometimes do not keep in the forefront. If anybody has any trouble bringing the issue to their company's attention, that calculation will help.

MR. GUSTAFSON: Any other comments?

MR. REISKYTL: I think, Gus, we should make one other thing clear. It was implied in one of your earlier answers on direct recognition that we will continue to be on a portfolio basis. It may be helpful to state that explicitly, as we may have left doubt in someone's mind.

MR. GUSTAFSON: Thank you. I had intended to stick that in and then I forgot it. Any other comments or questions from the audience? OK, we will adjourn these few minutes early. I want to thank you, a fine audience and thanks to my panelists.