RECORD OF SOCIETY OF ACTUARIES
1981 VOL. 7 NO. 4

CHANGES IN LIFE INSURANCE LAWS AND REGULATIONS: WHAT DO WE NEED AND HOW CAN WE GET IT?

Moderator: CHARLES E. ROHM. Panelists: WARREN D. ARTHUR IV, RICHARD A. EDWARDS**, RICHARD V. MINCK*

Continuing economic, social and political turbulence make these times increasingly difficult for the life insurance industry. Current laws and regulations were designed for a different environment. Companies are searching for strategies effective for the current environment. These strategies involve new types of contracts and different distribution methods. Increasingly, companies have found that the legal and regulatory situation severely limits their options.

1. Are new directions in regulation required by changing circumstances?

2. Do customers need new forms of regulatory protection because of new contracts and distribution methods?

3. What types of laws and regulations should be changed, dropped, or added?

4. Are needed changes possible to secure? If so, how?

MR. CHARLES E. ROHM: I will start with some background observations about government and the life insurance business. Dick Minck will follow with comments about economic problem areas and their regulatory implications. Dick Edwards will talk about political and social problem areas and their regulatory implications. Warren Arthur will finish up by giving us the legislator's perspective on regulation of life insurance.

Government involvement in our business is pervasive. It is a mixed blessing. At times it is beneficial and welcome, at others it is at best burdensome, and can be even destructive. Government acts as both a regulator and a competitor of our industry. Both of these activities create many issues. In our presentation we will try to look beyond specific issues to see the broad overviews.

Let us take a quick look at some basic issues:

1. Who performs the insuring function, the private sector or the public sector? Currently in the United States, about one-half of the insuring function is done by government. The other half, our half, is subject to a variety of regulation. The government half is not, it writes its own rules.

2. Who should regulate the private sector insurers? How should it be managed?

* Mr. Arthur, not a member of the Society, is a state representative in the South Carolina legislature.

**Mr. Edwards, not a member of the Society, is a Senior Vice-President, Government Relations for the Metropolitan Life Insurance Company.

3. As to the portion of the insuring function left to the private sector, what share shall be performed by (1) life insurance companies or by (2) self insurance and captive insurers? What role has government played, as a regulator, insurer and tax collector, in determining the size of these relative shares?

4. Within life insurance companies, to what extent will government regulatory and tax policy determine the relative importance of our two major functions: (1) insuring and (2) investing?

5. To what extent shall government use the life insurance industry as an instrument of social reform? I have already mentioned three areas of government activity that shape our industry -- insurance, regulation and taxation. This fourth one may be the most significant of all.

6. Will government continue to establish clearly defined roles for financial institutions? Specifically, will life insurance companies continue to have the exclusive ability to provide contracts involving life contingencies?

ECONOMIC PROBLEM AREAS

MR. RICHARD V. MINCK: It is the nature of governments in general and legislatures in particular to deal with the problems of the people. Economic problems are particularly sensitive. I would like to review for you some of the regulatory and legislative responses that are taking place as a result of our economic situation.

The disturbing combination of continuing inflation in a stagnant economy, and an apparent endless succession of government deficits has led to a growing concern on the part of the public about where the American economy is and how much further it is likely to go in the direction of poor performance. This was a major contribution to the unexpected results in the November 1980 election. The election produced a major change in direction toward solving economic problems, which was embodied in the much publicized legislation designed to reduce the share of gross national product spent by the federal government and to increase the role of the private sector. During the passage through Congress, there were discussions of the need for basic changes in tax policy to encourage savings rather than consumption and, thus, to create the capital needed to rebuild the industry of the United States, increase productivity and turn the economy around.

A. Economic Recovery Act of 1981

On August 13, 1981, President Reagan signed into law the most sweeping tax reduction measure in the nation's history. This new law, which is entitled the "Economic Recovery Tax Act of 1981," provided significant tax reductions for individuals and business amounting to almost $750 billion over the next few years. The new law contained several provisions of particular interest to the life insurance business, including changes which should encourage additional savings aimed at eventually producing retirement income.

The new law provides an employee retirement savings deduction whereby employees who are active participants in an employer-sponsored or government plan can obtain a tax deduction each year for up to $2,000 contributed to an Individual Retirement Account or Annuity (IRA) or as a voluntary contribution to the plan. This provision marks the culmination of an

effort that began over a year and a half ago to secure the enactment of legislation which would encourage additional savings for retirement through income tax deductions for contributions to qualified pension plans by plan participants.

The new tax legislation raises, effective in 1981, (a) the annual contribution limit for IRAs from the lesser of $1,500 or 15 percent of compensation to the lesser of $2,000 or 100 percent of compensation; (b) the spousal IRA limit from $1,750 to $2,250; (c) the maximum annual deduction for contributions to a defined contribution Keogh plan (H.R. 10 plan), a plan maintained by Subchapter S corporation or a simplified employee pension (SEP) from $7,500 to $15,000, and (d) the compensation taken into account in determining permitted annual benefit accruals under defined benefit H.R. 10 or Subchapter S plans from $50,000 to $100,000.

The new law also provides, effective 1985, for an interest exclusion of up to $3,000 on net interest ($6,000 on a joint return). Of importance to the life insurance business is the fact that the new law adds insurance companies to the list of eligible payors of excludable interest. Thus, the interest paid by an insurance company which is eligible for the exclusion would include interest on prepaid premiums, life insurance proceeds left on deposit and policyholder dividends left to accumulate at interest.

1. Potential Problems. While the changes I have just mentioned should benefit our business, the new law also contains a provision which was designed to aid the financially troubled savings and loan industry but which may cause problems for us. The new law provides a lifetime exclusion from gross income of $1,000 ($2,000 in the case of a joint return) on interest earned on qualified tax-exempt savings certificates. Qualified tax-exempt savings certificates (all-savers) are one-year certificates issued after September 30, 1981, and before January 1, 1983, by a qualified depository institution with a yield equal to 70 percent of the yield on 52-week Treasury bills. Life Insurance companies are not included under the definition of "depository institutions."

We are concerned over the potential adverse impact of this provision on capital markets in general and the negative effect on life insurance products in particular. We do not believe that a significant amount of new savings will be generated but rather that the source of funds will be from existing savings with a resultant disintermediation problem. In our case, policyholders may remove the cash values from their life insurance policies or annuities in order to buy all-savers certificates from banks or savings and loans.

The new law also makes several changes in the estate and gift tax provisions of the Internal Revenue Code. For example, beginning in 1982, the maximum estate and gift tax rates are reduced over a 4-year period in 5 percent increments from 70 percent to 50 percent. Also, the unified estate and gift tax credit is increased gradually from the present $47,000 to $192,800 over six years beginning in 1982. Thus, cumulative transfers exempt from estate and gift taxes increase from $175,625 under present law to $600,000 in 1987 and subsequent years. The new law also provides an unlimited marital deduction for both estate and gift taxes and increases the amount of the annual gift tax exclusion from $3,000 to $10,000 per year.

2. Impact on Potential Revisions of Insurance Company Taxes.
As I mentioned previously, the new tax law provides tax reductions for individuals and business amounting to almost $750 billion for fiscal years 1981-1986. Of this amount, only $153 billion is attributable to business tax cut provisions. Of this $153 billion, approximately $145 billion is attributable to capital cost recovery provisions, $2 billion to corporate rate reductions, and the remainder to other business tax cut provisions. There is little or no direct impact on life insurance companies of these corporate tax cuts, but there are a couple of indirect effects.

First of all, the reductions for accelerated depreciation are of less value to financial institutions than to other businesses. Therefore, life insurance companies are likely to end up paying a larger share of the corporate income tax than had been true in past years. This may make them potential customers for leasing arrangements of the type authorized by the new law.

Secondly, once the Administration concluded that the substantial tax cut just enacted would result in a unsatisfactory level of budget deficit, they asked Treasury to develop a package of tax increases that would raise approximately $3 billion in fiscal 1982. The Treasury has developed no final recommendations, but it became known that among the things they are considering is the repeal of the election afforded by Section 820 of the Internal Revenue Code for the use of companies with a modified coinsurance arrangement. Such action may accelerate the consideration by Congress of needed changes in the life insurance company income tax act.

B. Inflation, Existing Policyholders and New Products

The sharp inflation experience in the seventies gave companies a series of problems in product design and pricing. These, in turn, have created problems for regulators and activities within legislatures.

The rapid increases in levels of interest rates has led to increased activity in both policy loans and surrenders. This, in turn, has called into question the soundness of existing statutes requiring rather high cash and loan values and limiting interest rates on policy loans to 8 percent or less. As a result, the NAIC adopted revisions to model laws last December, and legislation has been enacted this year in about 51 states changing both policy loan and nonforfeiture and valuation laws.

Such legislation, of course, helps the situation only so far as new contracts are concerned. It provides no help for existing policyholders unless they are willing to exchange their policies for new ones on favorable terms. Inflation has, to some extent, increased costs for existing policyholders with participating contracts because of its effect on company income taxes. The business hopes to get Congress to enact needed relief in this area.

In an attempt to reflect new money rates more fully in pricing or illustrating the prices of products, companies have developed a number of variations on traditional life insurance policies. These include combinations of term life insurance with annuities or other savings vehicles; non-participating life insurance policies under which benefits may reflect excess

interest being credited; policies with non-guaranteed premiums; and a number of other approaches in various states of preparation. Each of these new products carries with it a set of questions for legislators and regulators. The questions include: How should the policy costs be illustrated and what form of disclosure is relevant? To what extent do state and federal securities laws apply to the products and to those selling them? How should existing nonforfeiture and valuation laws be applied? How should individuals buying such products be taxed? How should companies selling such products be taxed?

Some of these questions have been answered or are in the process of being answered. However, it will be sometime before enough work has been done to define just where these products fit in the general scheme of state and federal regulation and taxation. A successful outcome will require the exercise of forebearance and a lot of good will from all parties.

C. Competition Among Financial Institutions Reflecting Economic Stresses

The pressures that inflation has put on costs of operations of life insurance companies and the increased difficulties of financing and bringing along new agents have been factors in persuading some companies to add other types of activities. Personal line property and casualty insurance has been tried with varying degrees of success. Multi-line companies have, of course, been in existance for many years; but the number of established casualty companies with life subsidiaries and vice versa has grown quite rapidly in recent years. This sort of diversification falls neatly into existing regulatory patterns.

Life insurance companies have been offering their customers mutual funds, including money market funds. Their agents have become registered broker dealers and they have opened accounts for their customers from which withdrawals may be made quite readily. Thus, they have joined brokers in what might be described as first steps into the business of banking.

Correspondingly, banks and savings and loan associations have been pressing for relaxation of their regulation under Glass-Steagall to permit them to operate as brokers or to sell insurance. There will be hearings this fall before the Senate and Housing banking committees and the Administration favors a drastic cut in existing regulations. If this results in a general blurring of the traditional lines separating the activities of various financial institutions, we may expect considerable activity among their current regulators -- state insurance departments, state and federal securities regulators and state and federal banking regulators -- to establish who is responsible for which activities and which institutions. Meanwhile, the pace of merger and acquisition is, if anything, being stepped up as companies position themselves for a new environment.

D. Public vs. Private Providers for Retirement Security

Our economic problems may have a profound effect on the degree to which the government and private industry share in providing retirement income. On the public side, Social Security is now encountering serious short-term and long-term financial problems. To a considerable extent, this is the result of inflation and economic recession in recent years which have pushed up benefits and depressed receipts. The entire system could go broke in a few years, depending on economic conditions.

This is something Congress has been struggling with, but the politics of it have proved just too difficult. There will be little or no action in the current Congress except for minor changes needed to move money from one fund to another to not run out of cash.

The problem is getting more serious and I believe the next Congress is going to have to deal with it. The American Council of Life Insurance has been active in recommending solutions and we are hopeful that some way will be found to place Social Security on a sound financial basis. In our opinion, in addition to other reforms, this requires reform of the present method of indexing benefits and a later normal retirement age under Social Security, phased in gradually to enable individuals to adjust their retirement plans.

Concerns about the ability of people to retire off of Social Security with adequate income led to appointment of the Presidentual Commission to investigate private pension plans. However, the report of the President's Commission on Pension Policy, which was issued in February, appears to have had little impact on Congressional legislation to date. Much of the reason for this lies in the last election. There is considerably less support in the present Congress than in the last for additional regulation to achieve desired objectives. Also, this Congress is pretty much worn out by the struggle that it had over the tax and expenditure bills early this year, and any action probably will not take place until next year.

We are pleased that the Commission assigned an important role to voluntary savings, including voluntary pension plans, in meeting retirement needs. The Commission, for example, recommended tax incentives to increase private retirement savings including tax deductions for employee pension contributions. The Economic Recovery Tax Act of 1981 moved towards this goal by allowing employees covered by pension plans to participate in IRA's or to take tax deductions up to the IRA limits for their own voluntary contributions to pension plans. However it also included a proposal for a system of employer-financed mandatory pension plans. The country and the Congress is a long way from being ready for this kind of mandated coverage.

In summary, the report of the President's Commission contained both good and bad elements for the insurance business. Insofar as it recognized the desirability of encouraging voluntary pension plans through tax incentives, it offered the private sector an opportunity to expand voluntary provision for retirement needs. However, some of the proposals, notably the proposal for mandatory pension plans, would have undesirable effects. Fortunately, as I have already indicated, proposals for such mandatory pension plans are not likely to be adopted within the foreseeable future.

POLITICAL AND SOCIAL PROBLEM AREAS

MR. RICHARD A. EDWARDS: Change usually provides both an opportunity for progress and a danger of regression. Whether any particular change has a constructive or adverse impact upon the affected institutions and organizations depends upon the accuracy with which its nature was perceived, how early that perception occurred, and the skill with which responses to the change were conceived and managed.

The single most important characteristic of the current relationship between government and the insurance industry is, in my judgment, that both parties to the relationship are in a state of turbulent change.

The very nature of insurance requires that its regulation be responsive to changes in the American economy, polity and society. Thus legislators who formulate insurance regulatory policy, and insurance commissioners who administer that policy, have an obligation to identify such changes and to modify their statutes and regulations, indeed their regulatory attitudes, in response thereto.

Early detection of economic, social and political symptoms of regulatory trouble for our industry is essential. Thus it will be my purpose to identify a few of the more important political and social changes which have direct relevance to the regulation of insurance.

A. The New Electoral Process

In modern America, the determination of issues to be placed on the public agenda, and the choice among alternate policy responses to each issue, occurs for the most part through political pluralism. That is to say, interest groups cluster together in temporary coalitions to seek the legislative goal upon which they have agreed.

There is nothing sinister about the process; it simply reflects a growing awareness on the part of thinking Americans that to achieve their public policy ends they must associate themselves with others having similar objectives. It is also, and perhaps more importantly, a response to the deep governmental intrusions into our corporate and personal lives.

The most obvious consequence of political pluralism has been a sharp decline in the importance of political parties. But of much greater significance is the fact that public policy issues are decided not by majority rule but by the coalition of interest groups having the greater strength. This, in turn, causes the public to view government as not responsive to its will; thus, we have the long trend of declining participation in both primary and general elections.

But interest group displacement of policital parties as instruments of public policy formulation is only one of two major trends in the political process. The other is, of course, the growth of participatory democracy through the increased use of initiative and referendum. Twenty-three states and over 100 cities now allow the initiative whereby citizens can draft legislation, place it on the ballot by petition and have voters decide directly whether or not it should become law. Between 1970 and 1979, nearly 125 initiatives were voted on at the state level -- almost twice as many as in the 1960s. Indeed, the initiative has become an important tool for building coalitions among different groups around specific issues.

But the defect of participatory democracy is also apparent. Most of the safeguards of the legislative process, safeguards against precipitate action in response to emotional or ill-conceived demands, are circumvented by the use of the initiative. That is to say, initiative provisions do not enjoy the benefits of hearings conducted before the appropriate committee of two Houses of legislature, conference committees seeking to compromise the differences between the two Houses, and gubernatorial review of the compromise so attained.

B. The New Federalism

The central feature of the new federalism, an integral part of President Reagan's program, is a redefinition of national and state governmental

responsibilities so as to more closely approximate the intention of the framers of the Constitution. Whether the states are prepared to accept such new responsibilities, and whether the national government is prepared to surrender commensurate tax resources to finance such activities, remain unanswered questions.

From the standpoint of insurance regulatory policy, it would seem that the new federalism would have the effect of reinforcing the McCarran-Ferguson Act and reducing any real threat of further growth in federal regulation of insurance. But there are at least two major developments which point the other way.

1. There is a growing cost consciousness among policyholders, particularly group policyholders, as they view the question of diversity versus uniformity of regulation. Uniformity of regulation does not automatically follow the adoption of federal regulation, but the attainment of uniformity at the state level is rarely possible.

2. The explosive growth of one-stop financial services, where each form of financial institution seems anxious to become involved in the delivery of all other forms of financial services, may be viewed by the proponents of centralization as beyond the effective regulatory capacity of the states.

In the evolution of government regulation of business, from the creation of the Interstate Commerce Commission in 1887 to the present day, two broad classes of administrative agencies have emerged.

The first is composed of the agencies whose regulatory responsibilities are defined by Congress or by the state legislature in terms of a specific industry. For example, transportation in the case of the Interstate Commerce Commission, communication in the case of the Federal Communications Commission, and insurance in the case of the state insurance commisssioners.

The second class encompasses those agencies whose regulatory responsibilities are defined in terms of a specific problem area irrespective of the industry in which the problem arises. For example, pollution for the Environmental Protection Agency, health and safety for the Office of Safety and Health Administration, and fair trade practices for the Federal Trade Commission.

As will be immediately apparent to this learned audience, the grants of authority to those two classes of administrative agencies by the Congress or a state legislature were rarely made with a sufficient degree of mutual exclusivity to prevent jurisdictional overlap and thus jurisdictional conflicts. Some conflicts have caused delay, confusion and expense for the regulated industries.

The life insurance industry and other financial institutions now appear to be entering a period in which such problems of delay, confusion and expense will be exacerbated by the advent of one-stop financial services. We have all witnessed the explosive growth in the diversification of financial service capabilities. The lines of demarcation among the various types of financial institutions are becoming less and less apparent.

The uniqueness of the life insurance industry, a basic premise of both the McCarran-Ferguson Act of 1945 and the Life Insurance Company Income Tax

Act of 1959, is rapidly disappearing. The proposed repeal of the Glass-Steagall Act, which as you know separates the banking and the securities functions, would further blend heretofore discreetforms of financial activity.

The political and regulatory implications of all this for the insurance industry are both clear and ominous. Many insurance companies of the future will no longer have insurance as their only or principle activity. Collectively, and in some instances individually, they will be engaged in services which are regulated by numerous departments of state government: the insurance department, the banking department, the securities department and others. Where will the regulatory coordination of these several departments occur?

The Governor will find it an impossible task because he cannot unilaterally make the statutory adjustments needed to correct the growing incidence of conflicting instructions from the various departments to a specific insurance company or other financial institution. The state legislature will also be unable to achieve the needed interdepartmental coordination because the legislative process is much too slow to be promptly responsive to each conflict as it occurs.

The persistent recurrence of conflicting directives to the same insurance company or other financial institution from various departments of the same state government, superimposed upon the current conflicts among the various states and between the state and national levels of government, could so augment the costs of compliance and diminish the capacity for prompt service to the public as to compel major changes in the regulatory structure.

The major changes could take at least three forms:

1. The most desirable form would be to reduce the causes of conflicting directives by repealing those voluminous statutes and innumerable regulations which prescribe in indefensible detail the manner in which a legitimate regulatory goal is attained. In short, the change might take the form of the long advocated shift to indicative regulation in which government prescribes the objectives to be attained but leaves to the regulated company the choice of means for their attainment.

2. Alternatively, each state government could reorganize its executive branch so as to consolidate all departments having regulatory jurisdiction over financial institutions: insurance companies, banks, savings and loan associations, mutual funds and others.

3. The least desirable form of change would be a preemption by the national government of all responsibility for regulation of insurance companies and other financial institutions. That would mean, of course, the repeal of the McCarran Act and the end of state regulation of our business.

We have long recognized the fundamental unfairness of marketplace struggles in which the competitors are bound by different rules. The Blue Cross hospital reimbursement discount, and premium tax exemption or a preferential rate for domestic insurers, are the traditional examples. But we are about to confront an era of unintended regulatory differences arising from

the fact that the competitors are regulated by different statutes and by different administrative agencies.

C. Deregulation

Most of the debate concerning deregulation has been addressed to federal administrative agencies but, because the insurance industry is regulated at least in part by several such agencies, the deregulation debate must be regarded as an important part of our regulatory environment.

The need for deregulation, at least at the national level, arose from government attempting to increase the scope of its authority to reach every facet of industry, without regard to the explosive growth of the technology in most industries and that change was occurring, to use Alvin Toffler's term, at a "Future Shock" rate.

The consequences were disastrous. By forcing business to allocate much of the limited investment resources to comply with mandates, funds were diverted from essential research and development. By increasing waiting time for return on investments, investment in new technologies was discouraged. By changing government standards so frequently as to increase uncertainty and reduce incentives, innovation lagged. Finally, government lost much of its capacity effectively to discharge those functions which only government can discharge.

The federal government found itself with 179 agencies employing 100,000 people and issuing on the average of 7,000 new rules every year. Compliance with those rules required the use of 4,400 federally approved forms, not counting tax and banking forms, and the expenditure of 143 million man-hours each year to fill out the forms.

The problem was further exacerbated by the Congressional habit of creating a new agency whenever it encountered a new problem, by the Congressional failure to make hard political choices among competing values when it defined the mission of an agency, and by the inadequacy of Congressional oversight.

As a consequence, Congress, and to a lesser extend state legislatures, are considering a number of regulatory reform techniques. They include the entire solar spectrum: Sunrise Bills which specify in advance precisely what an agency is supposed to accomplish; Sunshine Bills which open the governmental process to the media and the public by prohibiting closed sessions of legislative committees; High Noon Bills which review one agency each year and propose reforms which must be acted upon within a year; and Sunset Bills which require regulations, spending programs and even entire agencies to be periodically reapproved or pass out of existence. Cost/benefit ratios, regulatory benefits which impose annual limits upon the costs of compliance, and the various forms of legislative oversight -- fiscal, programmatic, administrative and legislative veto -- have also attracted increasing attention.

D. Social Problem Areas

Quite distinct from the economic and political trends to which this panel has already alluded, effective regulatory policy must recognize and respond to four major social trends.

1. The decline of the family. Between 1970 and 1980, there was a 65% increase in divorce, and a 157% increase in unmarried couples living together. Today only 8% of the nation's families include a working father, a stay-at-home mother, and one or more children. Our industry and our regulators must inquire to what extent the erosion of the family has led to an erosion of perceived need for life insurance, and to what extent marketing programs and their regulation must be modified in response to the decline of the family.

2. The decline of literacy in America. The Educational Testing Service has published results indicating that in 1980 the Scholastic Aptitute Test scores for American high school seniors seeking admission to college fell for the tenth consecutive year. Similarly, the 1975 Federal Government Adult Performance Level Survey found that 23 million Americans "lacked important functional competencies," and an additional 34 million "were functional but not proficient." Fifty-six million adults in America do not have a high school diploma! Thus we have declining literacy, a total mismatch of the information explosion and with the increasing complexity of our society.

3. Demographic trends. These trends have profound significance for our industry as this audience knows far better than I. For example, Social Security actuaries estimate that while there are currently 3.2 workers contributing to the system for each of the 36 million beneficiaries, there will be only two contributors for each recipient by year 2030. In 1950, there were 16.5 workers per beneficiary.

4. Social reform. Of even greater significance is the continuing and growing demand by government at all levels that our industry serve as an instrument of social reform. Insurance companies are ill-equipped to act in this role, but they seem to be given no alternative. Universality of coverage is held out as the goal to be achieved under flags labeled entitlements, risk free society, and the new egalitarianism.

   Socialization of risk through an elaborate system of cross-subsidization, involving maximum rates, pools for the poor and the uninsurables, guaranty funds and joint underwriting associations, has become commonplace. Risk classification has encountered regulatory restraints in anti-discrimination statutes which concede the validity of traditional morbidity and mortality underwriting standards but deny their current social legitimacy.

The life insurance industry has the professional competence and social obligation to confront each of these problem areas, determine which policy option will best serve its policyholders, and bring to bear its political resources to achieve the choice of that policy option by governmental leaders.

REGULATION FROM A LEGISLATOR'S PERSPECTIVE

MR. WARREN D. ARTHUR, IV: I hope to give you some insight into state government regulation and the way we feel about the life insurance industry. As a state legislator, I have never had any serious problem with the life

insurance industry. One reason for this is because life insurance is strictly voluntary. This is quite different from casualty insurance which has mandated coverages. If a person buys a life insurance policy, he does it on his own free will and this takes us off the hook. Second of all, life insurance has always served a very important purpose in this country.

However, we are now at a turning point, and we need to revise what we have been doing. Both the industry and the legislative bodies need to step forward and provide the necessary vehicles to remain competitive with the alternative investments available today. There is a gradual realization by the public that there are alternatives to buying life insurance. This is extending down to the middle income and even lower income classes. Banks and other financial institutions are really pushing low outlay, high interest investment programs such as the new all-savers tax-free investments. The public is becoming more and more aware of these types of investments. The life insurance industry needs to develop innovative policies to compete with these kinds of investments and then make the public aware of them. No longer can life insurance be sold by a "johnny nice guy" agent, who usually pushes whole life because of its higher commission. For people who have a difficult time saving and who have limited resources, the traditional whole life policy is a good vehicle to accumulate money for retirement while providing protection. But some people, especially low income and less educated people, do not realize that term insurance is a good vehicle to provide protection, while leaving money left over to invest in higher yielding investments.

One of the main problems I face as a legislator is the length of time necessary to get a bill through the legislature. I know actuaries feel an urgency to make changes which are needed. I feel that urgency also. Unfortunately, the legislative process operates like a turtle. It just eases along. I have had many tremendous disappointments during my legislative career because I could not get something when I wanted it, when I felt my constituents really needed it. But the same applies to industry. We are constantly faced with requests from industry of all types to pass legislation. It gets introduced, somebody objects and it is held up for several months. If it does pass in the House, it goes to the Senate. If it becomes stuck in a committee it may not get passed that year, not because it is not good legislation, but because of the legislative process. This slow process is in part due to compromise, not only between different parties in the legislature, but between the industry and the legislature. It is as much a responsibility of the industry lobbyists as it is the legislature to achieve the desired legislation. This quite often will mean sacrificing some of the things the industry really believes should be in a particular bill. We try to do what is right but compromise is the name of the game and the process is slow.

I am in favor of deregulation to the extent it is possible and it still protects the public. But you can also expect that to be slow, because of the many liberal state legislatures. Ours is not one of those but it still is one that would be called responsive to the consumer. Even so, I doubt if we would have any sort of wholesale deregulation any time in the perceivable future. We can start one step at a time. However, you must understand that when we start deregulating, we will be fighting the insurance department. They do not want to give up their regulatory responsibilities nor their jobs. You can bet they are going to be opposed to a lot of things we suggest. This is a fact of life in the states and in Washington. These agencies become set up and it is almost impossible to reduce or do away with them.

Another problem legislators face is the attitude and desires of their constituents. Legislators must think in terms of their constituents and how they feel. If our constituants perceive a problem which in reality is not there, a very real political problem arises. This can happen easily in the insurance industry because of the inherent complexities. Actuaries and others with your caliber of intelligence and education are viewed with a basic distrust by the average person, since they have a hard time understanding your thinking on many of the critical issues. It is very difficult to maintain credibility with the little people so to speak unless you can talk on their level. Sometimes that is very difficult.

Massive changes in the standard nonforfeiture law is something that is needed. To remain a viable and profitable industry, the nonforfeiture law as it now stands is going to have to be repealed. Once the general assembly realizes how the situation has changed and how it has affected the industry, we might be able to accomplish something in that area.

Regarding the 1980 amendments to the standard nonforfeiture law, I hope that the life insurance industry will work with us this year on this because I expect it is going to take some time to get it passed. I am probably talking two years, which is not an unreasonable time for a bill to take. We cannot get enough public interest in something when the companies are now making money. We know down the road what is going to happen. But the public sees the bottom line of figures and the general assembly is sensitive to the public. We can introduce the bill today and in two years when your profits are negative, we get it passed. The insurance commissioner has the responsibility to see that you remain solvent. But they are under pressure from the legislature and with this particular change the only thing they can do is recommend it to the general assembly.

DISCUSSION

MR. MARK R. GANZER: To Mr. Arthur's comments that actuaries do not talk on the level of the average person I would say this: Although I cannot speak for the rest of my colleagues here, I spend some of my spare time in "dive bars". I count among my friends and acquaintances a really diverse group of people from all walks of life. We are able to understand each other. I do believe it is possible to communicate.

In response to Mr. Edward's remarks on social reform, my company has been actively involved in community affairs contributing both financial and personal resources for at least twenty-five years. We do this because we are an important part of a community and we must give something more to the community than just employment. But I would suggest that we have not done an adequate job informing the public of our social contributions. I do not know if our shyness in publicizing our own efforts is caused by concerns that we may not always do the right thing and may subject ourselves to media harrassment, or whether we have just failed to capitalize on traditional public relations.

MR. EDWARDS: My complaint against life insurers acting as agents of social reform is limited to governmental compulsion as to the manner in which that instrumentality is expressed. Virtually every company has an active corporate responsibility program. This commitment to voluntary corporate social responsibility by the industry was recently reaffirmed at the Oakbrook conference in Chicago. What I am objecting to is government throwing out

an established system such as our risk classification system and imposing a different one, such as a mandated community rating system. Government has not denied the accuracy of the traditional data underlying our underwriting standards, but has decided that it no longer has any social legitimacy. Government is less well equipped than our industry to make such a determination.

MR. GANZER: To the extend that government is intruding in areas such as risk classification, I would suggest that we as an industry can take some of the blame. We have not explained our position well enough, often enough or persistently enough. To say it is all government's fault is overlooking something more fundamental. It is one thing to have high level industry representatives talk to government figures, it is something else to have constituents drop a note to a congressman and try to make some waves. This grass roots approach can be very effective.

To the legislators in the room, I say this: If the insurance industry has always worn white hats and done the right thing on a timely basis, and for the right reasons, we would not consider you to be our adversaries, but our colleagues or our bosses. The concept of insurance was originally developed as something almost sacred and holy. No one considered making a profit, although there is nothing wrong with making a profit. We are in this business because we provide a useful and valuable product. We stay in this business because we make profits. To the extent that from time to time we lose sight of our original objectives, we should be held accountable. In fact, there are greedy individuals and greedy organizations in the industry; their numbers are fewer than many consumerist advocates would like to believe, but their numbers are larger than the industry should tolerate. What bothers me more than greed is acceptance of the status quo and people and organizations who have lost sight of our original commitment.

MR. JOHN O. MONTGOMERY: This last year the state of California removed the requirement that insurance companies could allow no more than the usury rate on any investment, including policy loans. This means that in California there is no limit on policy loan interest rates or mortgage loans. They also passed a law on variable mortgage rates of interest. Also a law was passed a year ago which requires all regulations to be reviewed before the end of 1982. A regular time schedule has been set up for all regulations, not just the insurance department. One of the things it does is to remove all reporting forms from regulations. They can be put out as bulletins or something but they cannot be included in regulations. It means a great deal of reduction in massiveness of the California administrative code. As an example, we are in the process of reviewing the credit life and disability regulation. It started out with some seventy pages and we are down to 25 or 30 pages. It shows what can be done in simplification. We have gotten very good response so far.

MR. GANZER: For those legislators that would like an example of how to regulate insurance in a perhaps more effective way, there is an excellent model to the north of us in Canada. By more effective, I mean a manner in which the consumer would come out with more for his dollar. There are very competitive products in Canada, products that are not even legal in the states.

MR. MONTGOMERY: I want to point out that the Canadian regulation regulates some 400 companies, including both life and casualty. They have a staff and a superintendant office of some 13 Fellows and they are intimately in

contact with the actuaries of those 400 companies. In California we have about five or six hundred life companies and about five or six hundred casualty companies, and a staff of 2 Fellows of the Society of Actuaries. There is a problem trying to keep the same basis of familiarity.

MR. EDWIN E. HIGHTOWER: On the general subject of decreased regulation, there is a growing belief among actuaries that the state of regulation in the United States has resulted in anti-competitive results. It has created a situation where the United States life insurance industry is unable to respond to changing economic conditions and has significantly stifled creativity and innovation in product design. For the gentlemen on the panel and others who may be in the audience representing both the industry and the regulators, I would like to hear whether Europe, Great Britain and others are really all that much better off.

MR. MINCK: I would like to respond on behalf of the United Kingdom. As John Montgomery pointed out the United States is quite a different place. The languages are somewhat similar but the cultures are very different. The scales of population are very different and they can regulate on the basis of what actuaries think is reasonable at that time. England has also allowed so much in the way of product innovation that I do not know if anyone sells life insurance there any more. The Prudential through the Hambro organization sells something that looks sort of like life insurance, but everyone else is selling something that would be quite different over here.

One of the things that regulation is supposed to do is stifle innovation when it thinks innovation may be harmful to the people it is protecting. Sometimes it will be wrong and it will stifle the innovation that would have been well not to stifle. But that is inherent in the nature of the animal. How do you go from an industry that has been highly regulated for the past 75 years (which was necessary for the protection of the public) to the sort of freedom that you have in some other environments? The first step is to obtain a concensus that that sort of change would be desirable. We have to do it very carefully and a little bit at a time. I do not believe we can start today and by next year end up with a much freer environment than the one we currently have. But in order to make any progression in that direction we have to recognize why we are where we are.

MR. ERNEST J. MOORHEAD: It would be helpful for the panel to enumerate specific pieces of legislation under consideration that affects the consumer. As an example, in Wisconsin there has been a good deal of discussion about eliminating the anit-rebating laws. I wonder if it would be possible to direct the discussion to some specific items such as this.

MR. MINCK: As Mr. Moorhead pointed out, in Wisconsin there was a proposal to repeal the prohibition against rebating by insurance agents of some portion of their commissions to customers. There was a hearing in Congress quite recently on the same subject. It was felt that small businessmen would profit particularly from the possibility of receiving rebates from life insurance agents. The history of course is that such practice has been prohibited broadly throughout the United States for the last 75 years. The reason for such statutes is that at the time, rebates were being given to the larger policyholder. The result was to increase the cost for the smaller policyholder. The combination of not getting rebates and the increase in the level of agents' commissions that had gone up in

order to support the rebate system resulted in a substantial discount by policy size at the time. This question has been taken up by some consumers groups including some in the Ralph Nader organization on the ground that permitting rebates by repealing those laws would permit customers to get life insurance at lower prices.

MR. JULIUS VOGEL: It is my firm belief that the repeal of the anti-rebate laws would be anti-consumerist in effect. It could only lead to an increase in the cost of insurance to the average person. I was really suprised to find Ralph Nader on the side favoring rebating. I would have expected to find him on the other side in favor of keeping the anti-rebate laws as a way of continuing some consumer protection.

MS. BARBARA A. KELLER: Several years ago I was asked to do some asset shares for one of our Phillipine clients. I had a difficult time coming out with anything positive. The main problem was the extraordinarily high first year lapse rates which made a sensible asset share very difficult. I learned the reason for this was rebating. I must confess ignorance for I do not know whether rebating is against the law in the Phillipines or whether it is simply not enforced. In any event, the agents would prey upon people who were ignorant, would get them to buy a policy, and would endulge in rebating. The next year of course these people could not pay the premiums which accounts for the very high lapse rates. Permitting rebating is a terrible disservice to the people of the Phillipines and was very unprofitable for this company.

MR. GARY CORBETT: In our company, and I am sure in other companies as well who have sold policies with substantial early cash values, we discovered a substantial amount of rebating going on. One of my frustrations with the state insurance departments is when we catch some of these agents it is very difficult to get any action taken against them.

I do want to talk about the subject of overall deregulation of the life insurance industry. I would like to construct a senario and then would ask for comments from the panelists as to whether they see any likelihood of this coming about. In Dick Minck's early comments he mentioned that banks and saving & loans are going to be substantially deregulated and get into business traditionally occupied by the stockbrokers and the life insurance industry. The problems of the savings and loan industry are going to cause this to happen if nothing else. If the savings and loans essentially get banking powers, banking powers will get savings and loan powers and I have to see the coming together of insurance companies under this same type of umbrella. If the banks are essentially regulated by federal authorities but without the same type of restrictions on the financial aspects as life insurance companies, banks are inevitably going to develop products similar to insurance. If changes in regulation of the insurance business are required, it can happen much more rapidly at the federal level. Companies that operate in essentially all 50 states just cannot get rapid change in state regulation. Do you see those things coming together, that is moving towards more federal regulation in the insurance area combined with deregulation?

MR. EDWARDS: Movement to greater federal regulation is the obvious response to the dilemma you just described. But it would be very difficult to attain even if we wanted to. The federal regulatory structure with certain limited exceptions has so discredited itself and has performed in such an irresponsible way that there are many authors making a very good living poking fun at

it. As a consequence we have the President of the U.S. appointing a task force on regulatory reform chaired by the Vice President, we have bills pending in the Congress for regulatory reform, and we have people like Senator Proxmire continually reminding the public of just how silly regulation can get. The Federal Register has become more fun to read than the New York Times. On a single day for example OSHA publishes a requirement that there be sirens or warning sounds of some kind on industrial sites, and two and one half columns later in the same Register they require the same people working on those industrial sites to wear ear plugs in the name of noise pollution. The literature is filled with this. I am not making fun of federal regulation per se, but I do think it has reached a point of irresponsibility where it is undesirable for the life insurance industry to seek a shift from state to federal regulation as a means of achieving equality of competitive opportunity with those institutions such as banks and savings and loans that are becoming our competitors. Congress is in a mood and the President is certainly in a mood to clip federal regulation. I share your concern 100%, but I would hate to see the solution occur at the federal level.

MR. MINCK: I would make one observation about federal regulation and the prospects of it. There is one agency that nobody thinks of as being inefficient or ineffective, namely the Internal Revenue Service. But even the IRS is slow to respond. For example,the treatment of group term life insurance in section 79 took about two years, and there are still wide questions unanswered. The idea that you can get quick action from the federal bureaucracy is theoretically correct. But in practice they do not act quickly when the problems are tough ones. There is in all of us an instinct for self preservation and the people in Washington are uniquely equiped to study a problem for as long as it takes to be no longer dangerous to them as individuals. One thing that has tended to keep people from pushing too quickly towards federal regulation is that nobody has felt there would be a withering away of the states if we got federal regulation. In fact we would end up with two levels of regulation, as some banks and security dealers have now.

MR. GANZER: Banking institutions were the first major financial institutions to request and to obtain "exclusive" rights to do banking. They did pay a price. The price was legislation. Likewise, the insurance companies paid the price for being the sole providers of insurance by subjecting themselves to legislation at both the state and federal level. A classic paper entitled "Marketing Myopia" describes the rise and fall of the railroad industry in this country. The railroad companies considered themselves to be in the railroad business as opposed to being in the transportation business. Therefore, when they obtained exclusive rights to the railways, they gave up their rights to the roadways and the airways. Probably all I can conclude from this is that one should be very careful about what one asks for. One may get it.

To the suggestion that one-stop financial service organizations be given special regulatory considerations, I would say this: based upon my own experiences, a large financial service institution specializing in one particular field (i.e., banks, insurance companies and brokerage houses) typically provide service inferior to small financial institutions. From this I infer that what may be needed is new, expanded legislation for one-stop financial service institutions. If large specialty institutions cannot do an adequate job, how can large all-service institutions be expected to?

MR. LOUIS GARFIN: I suspect that many people who speak strongly in favor of deregulation have in mind deregulation which is favorable to their interests. If the deregulation was broad and general it might not always seem so attractive. There is a very good example in the controversy over the anti-rebate laws. It is perhaps ironic that the people who are regulated by those laws (the agents) are now supporting in large part the continuance of those regulations. The Nader organization which is presumably speaking in the interest of consumers, is supporting the elimination of them at the same time the consumerists are saying people should be charged the same price for their insurance regardless of any classification. This would be obviously a step in the opposite direction. It seems to me an excellent example of the fact that people speak in terms of their own interests rather than of general principles in some of these matters.

MR. ROHM: I find myself agreeing with you as much as it embarrases me to do so. There really is a love/hate relationship with our regulators and we want to pick and choose our regulation and the degree in which it is applied to us.

MR. FRED W. SHERRON: It is true that regulation has stifled the insurance industry and the design of new products. But on the other hand there has been 75 years of fairly credible history and let us consider what might have happened if we had not had this regulation. I see a picture of many widows cheated out of their savings, bankruptcys and insolvencies. Regulation does serve a good purpose. Maybe what we need is a more responsible regulation. It is easier to say that than to get it.