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INDIVIDUAL LIFE INSURANCE PRODUCT DESIGN UNDER CONDITIONS OF INFLATION

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1. What are the needs and interests of potential customers during periods of inflation? Are there differences between the needs and interests of customers of career agents, insurance brokers and stockbrokers?

2. What problems are created in traditional life insurance product design during periods of inflation?
   a. For the customer.
   b. For the life insurance company.

3. What solutions are available to life insurance companies today?
   a. Product design choices -- inflation adjustments, tax shelters, flexible products, increased emphasis on investment alternatives.
   b. Cash management account.
   c. Dynamic actuarial assumptions.
   d. Policy loans, nonforfeiture values, tax efficient design.
   e. Other.
   Do these meet the needs/interests of customers?

4. What solutions may be available in the future?
   a. Are changes needed in regulation?
   b. What are the product designs of the future?

MR. ALLAN AFFLECK: The overall theme of this meeting is Inflation and our Changing World, which provides considerable room for talking about solutions to problems created by inflation. Our panel's challenge today is to move ahead from the theme of the opening keynote presentation by Ashby Bladen yesterday, which was entitled Inflation and the Decay of our Financial Institutions. Our panel sees the problems created by inflation for both our companies, but we also see some solutions through product design and will be talking about them this morning.

Our panel this morning includes the classical Society of Actuaries representation. We have a consulting actuary, someone from a stock life insurance company, somebody from a mutual life insurance company and one non-actuarial maverick thrown in to keep us on our toes. I think you will find the different backgrounds of the panelists to be of interest as we talk about these different issues.

Larry Edris has graciously pinch hit because Ken Clark was unable to be here. Ken's doctor said that he couldn't fly, due to some sinus problems. Larry is second Vice President in charge of product development at Lincoln National Life. He has been heavily involved with the marketing side of his company since Lincoln has restructured and redefined their posture in the market place over the last eighteen months. Our next panelist is Wil Kraegel, who

*Mr. Snyder, not a member of the Society, is Senior Vice President of Dean Witter Reynolds.

is Managing Actuary from that quiet company we all see and hear so much about on T.V. these days. Wil is active in the product development function at Northwestern Mutual and brings that perspective to our panel. Our final panelist is Alan Snyder, Senior Vice President of Dean Witter Reynolds and a member of his firm's management committee. He has overall responsibility for Dean Witter's insurance services and other new product related development. After so much discussion in the press and at this meeting about the impact the securities firms are having on our industry, we wanted to have someone with Alan's background to be with us here today and we really appreciate his coming to Houston and being a part of our panel. He refers to himself as a broken down stockbroker. I don't know if that is true or not, but I think you will find his comments of interest this morning.

The approach we are going to take is to work through the topics in the program one by one, with one or more panelists presenting their comments as we go through them. This is an open forum, which means that we are leaving approximately one-half hour at the end of our session for discussion and we hope that there will be audience participation in the form of questions and comments.

The opening question in the program is "What are the needs and interests of potential customers during periods of inflation? Are there differences between the needs and interests of customers of career agents, insurance brokers, and stock brokers?" Larry Edris will lead us off.

MR. LARRY EDRIS: The current period of inflation has permanently changed the public's real and perceived needs for individual life insurance. Never again will level premium, level benefit permanent plans be virtually the only product to meet the needs of the vast majority of our customers. Term insurance is no longer viewed only as a temporary solution for buyers until they can afford permanent coverage. The marketing of life insurance as a vehicle for avoiding or deferring taxes is no longer limited to a small segment of our total market.

Inflation has had a dramatic impact on our business and the topic of our discussion, product design. Before we look at some of the solutions available today and hopefully in the future, let's look in more detail at the needs of our customers in these inflationary times.

The need for much larger death benefits is obvious. Not so obvious are the still larger death benefits needed in the future if inflation continues. How can buyers be certain that today's policies will be adequate tomorrow? How can their insurability be preserved and their coverage increased as needed?

Inflation has made consumers more concerned about and aware of the cost of all of their purchases, and life insurance is no exception. No income level has escaped the squeeze of rising living costs and lagging disposable income.

More and more buyers find themselves simply unable to pay for the amounts of level premium protection they need regardless of their personal preference for term or permanent insurance, even though the unit prices of our products are falling. Greater price conciousness has led to price competition. Our buyers need to be able to determine the relative cost of different and similar products to make intelligent decisions. Can they rely on their agent?

Who will advise them? They don't want to support an inefficient distribution system. And they don't want to pay for unnecessary administrative systems and costly overhead. But life insurance is complex. What is the most cost effective combination of distribtuion system, administrative system and level of service.

As inflation increased the returns on all types of investments, the public became more aware of the investment aspect of permanent life insurance. This has contributed heavily to the trend away from permanent plans and to attempts by our industry to redesign products to lure back those investment dollars. But inflation makes it especially difficult to set aside funds for longterm savings, and if we are to capture a large share of those savings, the buyer must receive a competitive return. Our customers are going to compare their life insurance investment with alternatives in terms of safety, flexibility, tax treatment, liquidity, service level, and control.

As taxable incomes climbed with inflation, so called "bracket-creep" under our graduated tax formulas became "bracket-leap." The unique tax treatment of life insurance became important to a large segment of our market. Our customers need products that take maximum advantage of our tax laws and the tax treatment of policyholders and beneficiaries.

Most of our customers already own life insurance, usually permanent life insurance. Inflation has created a real need for unbiased direction regarding their existing insurance programs. Should they continue to pay premiums on those policies and what should they do with their cash values? Who will give them impartial advice? Our agents? Our home offices? Other financial institutions?

In answering all of these questions we need to consider product designs that meet our customer's needs with respect to:

1) insurability
2) cost efficiency
3) investment features
4) tax efficiency
5) replacement
6) service capability

The second issue raised under this agenda item concerns the economic viability of various distribution systems, which may be used to reach and satisfy customers and their needs in periods of inflation.

There are clearly no easy answers here, but it would seem to me that the distribution system questions could be the most significant as we move into the 80's. While I do not have any firm answers, my company did spend a great deal of time and effort in analyzing this question recently, and I would be happy to share with you some of our observations.

To address these distribution system questions, a clear feeling for market segmentation is unquestionably of primary importance. Without it further analysis may not be meaningful. We found the most useful market segment matrix to be one which had income and wealth levels of the customer along one axis of the matrix and the service level needs of the customer along the other. We did not find product differentiation to be very helpful in analyzing distribution systems. Clearly, a Whole Life policy can be used to satisfy both a very simple burial need, as well as very complex estate and business planning needs. Product packaging and other marketing support systems were also more meaningful in analyzing distribution system economics than the products themselves.

It was also quite beneficial in our analysis to break the process of delivering products to the customer into a "manufacturing process" and a "distribution process." Where we could, we tried to bring the interest of these two units together for mutually beneficial results. We did find, however, that this was not always possible. Because companies have limited resources from a manufacturing point-of-view, it will not be possible for companies to be all things to all people. Companies will need to realistically assess where they have sustainable competitive advantages, and concentrate their product development in the manufacturing and support of a limited number of products where those competitive advantages exist, or where they could exist by a reallocation of resources.

From a distribution system point-of-view, however, the sellers of financial services will need to have more products available than any one company can manufacture. I would stress here, that we believe that for our company to be viable, our sales people must become total financial planners. They must be total financial planners in both an insurance and a non-insurance sense. They must become familiar with not only insurance products, but other financial products such as tax shelters. The economic survival of our distribution system will depend upon our ability to modify that distribution system so that the agents have available to them all of the products necessary to potentially control the total financial needs of the customer. As I mentioned earlier, we do not intend to manufacture all of those products. For those products that we choose not to manufacture, however, we will establish distribution techniques which will make those products available to our agents in such a way that our distribution system also receives revenue.

In summary, the needs and interests of the customers during periods of inflation is changing and will continue to change. The structure of our distribution systems is also changing and will need to change as we move forward through the 80's. I do not have a strong feeling now concerning what the distribution systems will look like during the 1990's. It is quite possible there will be neither career agent systems, nor broker systems, nor other financial planner systems; but they may all begin to blend together. That is certainly one possibility we should consider. It is absolutely imperative however, to make sure that whatever distribution system we develop meets legitimate financial needs of our customers in these economic times.

MR. AFFLECK: Thank you Larry. Alan, would you like to add your comments on this opening topic?

MR. ALAN SNYDER: Thank you Allan for inviting me to be a panelist. It is a real pleasure to be here with all of you. Thank you for coming here this morning after surviving last night. Our remarks this morning really have a headline that says "These are the times that try men's souls."

Experiencing an economic revolution is not only trying but frightening! Thomas Paine wrote the phrase used as my headline on December 23, 1776 to describe the climate surrounding the American Revolution. He did not know that when the wrote it, it would describe the economic climate of over 200 years later as well. Inflation and our clumsy efforts to deal with it, or at times ignore it, have caused this condition. Four economic problems stem from this condition. They, in turn, have created a new consumer environment to which, as marketing and business people, we must respond if we are to be successful. (Please forgive the somewhat simplistic analysis, our brief time together demands it.)

First economic problem: Uncertainty. What evidence does the consumer have?

> The Conference Board's index of consumer confidence which rose in January for the first time in many months, fell again in February. The survey, which covers 5000 households around the country, indicates that consumers are especially uneasy about the current economy and have become less optimistic. (WSJ and NYT, 3/15)
>
> The jobless rate, only 3.5% of the labor force in 1969, has been on a rising trend since then. It was last clocked at 8.8% in February and is expected to go higher. (NYT, 3/14)
>
> The "uncertainty premium": Using the spread between the prime rate and the rate of inflation, Irwin Kellner, SVP and chief economist of Manufacturers Hanover Trust, calculates that the "real" rate of interest is now 8.08% compared to an average of 2% or less for most earlier years. The extra 6% is the premium demanded by investors for funds advanced in volatile markets during uncertain times. This may explain one of the great ironies of the credit markets of the last six months -- the sustained high level of interest rates despite sharply lower inflation. (NYT, 3/14 and 3/15)

From our first economic problem stems new consumer reactions, needs, interests, and desires:

a. More information and education - e.g. last year the insurance sales group of DWR held over 1,600 client seminars and should or could have done more. I.R.A. conflicting claims have baffled rather than provided information for the basis of making a decision.

b. Cynicism - All solutions are evaluated as if they will not deliver, e.g., a shift in consumer purchases from long bonds to intermediates; DWR ran advertising using a headline, "How to plan, make, and manage your fortune" against "A remarkable new program from Dean Witter Reynolds that gives you 17 financial services in a single account!" The former headline was not believed and had a lower response rate.

   Are there differences between the needs and interests of customers of career agents, insurance brokers and stockbrokers? Also, are there differences between the needs and interests of the sales people within the different distribution systems offered by insurance companies and securities firms?

Armed with some of the foregoing comments on economic problems and an assessment of the resultant needs and interests of the end comsumer, we have a choice of paths to travel. On one path, we might differentiate the type of consumer between alternative distribution systems. However, since most end consumers purchase insurance of some variety, we may simply be talking about sub-market segments of the macro insurance market. This appears to be the case but some generalizations about securities firm clients might be of interest. They are the demographic top end in terms of income and even more importantly accumulated wealth, having personal incomes usually over $35,000 and accumulated assets over $25,000. They are older and average 45 years. As an example, Merrill has over 600,000 clients in their Cash Management Account with an average asset value per account of $60,000; the total market for these central asset accounts is estimated at 3-5 million individuals. Not to be overlooked, discount securities firms cover a slightly more downscale audience but surprisingly not much. It seems that securities firms do cover only part of the potential market. And, when speaking with many insurance executives they assure me, often with a smile, that, their market is the entire U.S. population. Thus, an alternative to differentiating the type of consumer between distribution systems might be more constructive.

The alternative path to proceed on is to examine how these different distribution systems work by examining the sales process of each. If we are to create products for these different groups to sell we must understand how each sells and how each sees his clients to most greatly leverage the talent of these salesforces. In effect, we establish each sales person, insurance agent or stock broker, as our intermediate consumer. All of us know that if we don't sell them, they won't sell the end consumer.

The insurance agent and stock broker approach their respective businesses from different perspectives: The agent most distinctly by process, the broker by product. Our charts seek to compare and contrast these two important groups of sales powerhouses:

A Comparison/Contrast Between
The Business of Being An Agent Or Broker

AGENT	BROKER
Higher revenue per trade, invests more time in each transaction	Relatively lower revenue per trade - client defined as revenue unit not trade
Enjoys renewals	Starts each day with no revenue
Personal visit	Telephone contact & mail
Process oriented	Product oriented
Infrequent contact	Frequent ongoing interaction
Cumulatively large client book	Small number of active clients - large total
Limited product alternatives	Enormous selection of product alternatives
Believes client has one agent at a time	Understands client may have multiple brokers
Guaranteed Performance	Performance subject to events often beyond control
Most time spent prospecting	Most time spent selling & informing

Where does this lead us? To a whole raft of interesting ways to reach two different groups. Let me just share with you some thoughts on product design. I think between these two distinct distribution channels the insurance agent needs a relatively higher commission per transaction and maybe can live with a moderately less competitive product on a relative scale between the two. The stockbroker is quite happy to operate with a relatively lower commission. Why? He has a grab bag of products from which to generate a certain revenue stream for a client. However, the stockbroker must have a guerrilla-like competitive product. Why? He does not dare jeopardize the relationship he has with the client. He does not want to risk selling what he regards as an off-board product and risk the entire consumer relationship. I think the insurance agent can deal with more complex products, although they may have a lower degree of changeability, if you will. The stockbroker selling insurance needs simpler products. He sells primarily over the phone and he actually sells insurance over the phone. He, however, can deal with products that have a high degree of change. In our dealing with insurance companies they find it somewhat amazing that we can handle annuities that might change the interest rates as frequently as once or twice a week. The stockbroker can deal with that and in fact welcomes that kind of change. He can deal with products that have that economic vibrancy more easily, possibly because of the communications systems that stockbrokage firms have with their insurance agents.

The insurance agent can deal with consumers that have a high income. Generally we find in looking and talking to different groups that insurance agents don't feel as comfortable selling products that have a high premium component part. Single premium life insurance, which we have started to sell quite a bit of, is really more of the stockbrokers' product it seems. The stockbroker obviously goes after accumulated wealth.

Let me just summarize by saying that increasingly the agent and broker, while starting at different ends of the spectrum, seem to meet in the middle. The agent has a diversified product line because greater competition from discounters has needed to add more service through financial planning. In short, I think each is becoming more like the other and will increasingly find that to be true and, yet, we have to recognize that there are differences.

MR. AFFLECK: Thank you Alan. We are going to move on to the second question on our topic this morning. What problems are created in traditional life insurance product design during periods of inflation, both for the customer and the life insurance company? Wil Kraegel is going to offer his thoughts on this question.

MR. WIL KRAEGEL: What problems are created by traditional life insurance product design during periods of inflation:

a. For the customer?

   First, what do we mean by traditional life insurance product design? With the many variations which have emerged over the past several decades, there may be different interpretations of "traditional."

For our purposes let us define traditional as:

level face amount
level premium
fixed dollar
guaranteed nonforfeiture values
either term or permanent
either par or nonpar
standard dividend options

The problems created for the customer include the following, recognizing they involve some interdependency and overlap:

1) The level face amount is not consistent with the changing nature of the economy. At the time a policy is issued, the face amount is designed to accomplish a certain set of financial objectives which have an assumed set of approximate costs. Inflation changes both the mix of costs in meeting those objectives and the sum of those costs, while the face amount designed to meet them remains unchanged. As a result, the life insurance policy becomes progressively less able to meet its objectives. This result can be offset to a substantial degree, fortunately, through the use of dividend additions on participating policies.

2) While inflation causes the face amount to fall below the programmed needs, simultaneously the premium proportionately falls below the ability to pay. This is not always true, of course, but for the majority of policyowners income tends to increase through the effects of inflation. Traditional life insurance does not automatically adjust for the change in balance.

3) Premium dollars paid in have one level of monetary worth, while the benefits paid out have another, lower level - nonforfeiture values as well as face amount. The customer may feel a loss has occurred with the company somehow the gainer.

4) Inflation has an unevenness in its impact. Customers with indexed incomes, whether explicit in salary agreements or implicit in the nature of the occupation, may be little affected or even benefited, while those on relatively fixed incomes will be hurt. Also customers with primarily a debtor status will gain from inflation in the short run, while those with creditor status will lose. Any contract containing an investment element, such as permanent life insurance does implicitly, tends more to the creditor side.

5) These problems are more pronounced in permanent products than in term, in long duration term than in short, in nonpar contracts than in par.

b. For the life insurance company?

The problems created for the company include the following, again with interdependency and overlap:

1) The changing relationships between dollars paid in and those paid out may cause customers to become uneasy about the long term viability of life insurance. This can create a large marketing problem.

2) Inflation increases expenses, causing upward pressure on product prices. However, that factor may be more than offset by higher investment income causing downward pressure.

3) As simpler traditional products become less able to cope with inflationary change, more complex products are needed, increasing the resources needed and the resultant costs.

4) It is difficult for agents to keep up with inflation - incomes versus business expenses and personal requirements. On average they may, but those below average have another reason for leaving the field.

5) Inflation increases investment income for life insurance companies. However, the formula for Federal Income Tax is sharply progressive (for larger, older companies particularly). This reduces the marginal advantage of higher investment returns, making it more difficult to compete with other companies not so affected and with other savings institutions.

6) Inflation creates a subtle but serious psychological effect. Sales figures may appear to be favorable, with a respectable increase over the preceding year - something to be proud of - and yet sales actually may have declined on a real dollar basis.

7) Inflation highlights the incongruity of a guaranteed policy loan interest rate. It causes higher interest rates which in turn cause a run on policy loan values, whether for arbitrage or for minimum deposit purposes or as the lowest available rate for normal borrowing reasons. And policy loans diminish the role of life insurance in the economy, both in the financial programs of customers and in the provision of long-term investment capital.

8) Inflation causes high interest rates, which can depress the value of assets invested in long-term securities, thereby making it potentially difficult to meet policy loan and cash surrender value demands.

c. Toward a balance in perspective - There is no question that inflation creates great and grave problems for the economy in general and life insurance in particular. However, although we must be constantly aware of the problems, a balance perspective requires that we keep two other factors clearly in mind:

1) Life insurance can continue to exhibit a favorable performance by giving older policies the benefit of newer developments through some updating process.

2) Most other investment media have similar kinds of problems, although generally less prominently recognized and discussed.

MR. AFFLECK: Thank you Wil. We have looked at some of the needs and some of the problems today and now we are going to look at some of the solutions. First, in the context of today's environment, and then in terms of the future. Alan, would you like to lead off this discussion.

MR. SNYDER: We have talked about problems an awful lot this morning and now we are turning to some solutions. I look to the Chinese language to help me address this issue.

The Ancient Chinese Secret

In the Chinese language, whole words are written with a symbol. Often two completely unlike symbols, when put together, have a meaning different than either of their two separate components.

An example is the symbol for "Man," and that for "Woman." When combined, they mean "Good." How wise are the Chinese.

These two symbols above stand for "Trouble," and "Gathering Crisis". When brought together, as they are here, they mean "Opportunity."

As the answers always lie in the questions, so the opportunities of life lie directly in our problems. Thomas Edison said, "There is much more Opportunity than there are people to see it."*

Sharing the Chinese secret with you is far easier than applying it. Yet, Napoleon established how we must seize this opportunity when he said "Imagination rules the world."

First, we must remind ourselves, and I probably need the most reminding, not to fall into the trap the railroads did by describing their business as railroading and not transportation.

What is the business of a life insurance company? In the past, it was not limited to providing mortality protection. In an old brochure, on a life insurance plan, the first paragraph was twenty sentences long and ten of them mentioned the power of forced savings and the advantages of retirement income. Today, it seems that many insurance companies have forgotten their old emphasis and disdain those who sell annuities, universal life, and single premium life contracts, not to mention sellers of money market funds. Might this disdain be like the railroad baron who said airplanes were a passing fancy?

*Special thanks to Joel Weldon for sharing the Ancient Chinese Secret.

We have to go back to our roots just a little bit. Don't feel alone, because securities firms have the same sort of problem. Think of the image of an inverted triangle, where the individual consumer has an enormous amount of sources of funds that come in - earnings, capital, whatever. He keeps those in a depository institution while he is making up his decisions. Then he starts using those funds, obviously on basic needs for his housing, shelter and then maybe for some insurance, property and casualty. Then a little bit further down on that triangle, it is getting narrower all the time as inflation hammers away at it, he might think about some prudent savings. Then he might consider buying some life insurance. Inflation is shrinking that part of the triangle very quickly. Then, and last I am sorry to say, he thinks about investing to enhance his future. That is the position the securities firms have had and it is a pretty scary one because that part of the market has become smaller just as it has for life insurance.

Securities firms have acted and I think the same actions the securities firms have taken are open to insurance companies. And that is they have created what is called the Central Asset Account. Imagine, here's one account that takes the Securities Brokerage Account, adds in three different money market funds, adds in free checking, adds in charge card privileges, adds in the ability to get cash in over three thousand institutions across the United States and actually the world, adds in one statement that lists all the transactions for each one of those component parts and at the end of the year provides tax summary statements recapitalizing all those transactions indicating those expenses of the consumer that may be tax deductible.

This is an attempt by the securities firms to hop back up into where all that money is, move further back up that triangle--that inverted pyramid. I think that same opportunity is open to life insurance companies. Well, maybe that's too theoretical so let's get specific and examine some of the product opportunities that we look to.

Specific product alternatives offer solutions that are probably more quickly achieved. This audience knows what might be created profitably far better than this speaker. Thus, it's only with some fear and trembling that the following thoughts are offered.

1. Universal Life - In this market segment there may be more effective alternatives such as Executive Life's Irreplaceable Life concept. It offers:

   a) Simplicity
   b) Pure protection, i.e. not really term and side fund
   c) Unloaded costs
   d) Interest adjustability
   e) Use of current mortality tables
   f) Cash value rider for automatic increases in face amount.

   We believe that this approach is a partial alternative, but not mutually exclusive to Universal Life. However, it seems to afford more opportunity.

2. Variable life - Its day will really arrive as soon as one of you actuarial geniuses simplifies the product.

3. Single premium life versions such as Keyplan offer significant opportunity as long as the tax treatment is viable.

4. Tax sheltered life products such as Omni and Omega, if viable, can be sold in dramatically increasing amounts.

5. Annuities in all flavors will continue to grow unless acted against by the IRS. There is great opportunity for further market segmentation with indexing using differing guarantee periods. Variables began to sell once the education hurdles were jumped and even with 81-225 could rise like the phoenix if one of you provides the vehicle.

6. Hybrid products seemingly could be created using accumulation accounts of non traditional investments such as real estate. They would have great appeal.

In total, from the vantage point of a marketing person in a securities firm, insurance companies have the talent, marketing expertise, and product design capability to navigate well in this new environment. However, all of us must fly if we are to avoid being passed. When you're flying home at 600 miles an hour, ask if the jet plane has any rear view mirror--they don't--and maybe we too must look ahead more to master the Chinese secret.

MR. EDRIS: Before I get into my prepared comments, I'd like to just comment that it is amazing to me the similarities that I see in what we are trying to accomplish and what Alan is describing. Going back to my earlier comments about the blending of distribution systems, I think if you reflect on what we both said, you will see that maybe some of that is even beginning to happen today.

With respect to this section, I'd like to focus my comments on flexible products, because I feel this is an absolutely necessary feature of product design today. We're all familiar with adjustable life, indeterminate premium plans, term plans with a multitide of options, and now universal life. Flexibility is the feature common to all of these products. We don't need to review the reasons for this flexibility, but should consider where this flexibility is leading us and why it will benefit our customers, agents and companies.

For the customer, total flexibility can allow all life insurance needs to be met with one policy. The buyer will more likely be able to understand the coverage and know the amount of benefits and their cost, and hence more likely to make intelligent decisions. Buyers won't accumulate a box full of inappropriate policies. Agent and company servicing systems will be able to focus on keeping one policy up to date and in line with each customer's needs. Policies with fully flexible benefits and premiums are being marketed today. We'll be talking later about investment flexibility, which is limited today.

Agents will benefit through greater control over their clients, with assurance that all future life insurance purchases are somewhat locked in. The very nature of these flexible policies will shift much of the responsibility for repeat sales to the home office. This will free the agent to sell other products to current clients and prospect for new clients. Companies could experience dramatically better persistency under flexible products <u>if</u> they provide timely efficient service and keep their client's policies up to date. Reduced replacement risk will reduce future liquidity risk. If the flexible products can be designed to include market value cash out investment features, then the liquidity risk will be virtually eliminated.

Universal Life is a controversial subject. But regardless of the outcome of its various tax issues, its flexibility is a giant step forward, and a necessary development.

MR. WIL KRAEGEL: What solutions are available to life insurance companies today? In addition to those elements of product design most apparent to the customer, such as flexible products, there are several other possibilities with more significance internally:

a. Dynamic actuarial assumptions - In a relatively stable economy as we have experienced in the United States over the past two centuries, it seems eminently reasonable to make long-term guarantees using fixed actuarial assumptions. For example, state insurance regulations have long prescribed a maximum interest rate which may be guaranteed in the life contract. That has fluctuated within a narrow range, from 4% around 1900, down to 3% for decades and now back to 4%, even 4½% in some states and 5½% for some contracts. The maximum limit was satisfactory over those decades because the actual yields earned fluctuated not too far above and not often below the statutory maximum rate.

   Two-digit inflation has created widely available two-digit investment returns. And the combination of the maximum interest rate which may be assumed in the guarantees plus the strongly progressive Federal Income Tax formula has formed a dilemma. The low guarantee makes the life insurance contract appear uncompetitive with other investment institutions, while a higher guarantee would not likely be sustainable over several decades into the future.

   One possible solution is a dramatic departure from the long-held concept of static actuarial assumptions. Instead of guaranteeing nonforfeiture values based on a fixed assumed interest rate, the contract could specify values based upon objectively determined measures of performance. This could apply to factors other than interest, but in the inflation context the interest rate is the relevant factor. This would help to minimize the conflict between investing for maximum advantage of current yields vs. investing for the long-term guarantees.

b. Policy loans - At least 2 approaches are currently available to reduce the impact of inflation through the policy loan window - the market loan policy loan interest rate and the direct recognition of policy loans on individual policies. The market loan rate is now approved in 21 states and is an approach used by a few companies since the beginning of 1982. Instead of specifying a policy loan interest rate in the policy, the loan provision permits policy loans to be made subject to interest charges determined by the current level of the Moody's AAA long-term bond index. Although this may still be lower than other yields available, e.g. money market rate, it reduces the incentive for borrowing substantially by cutting down the arbitrage differential and by reducing the subsidy of borrowers by non-borrowers.

The direct recognition approach also came into use by a few companies in the past year or two. It too reduces the arbitrage differential substantially, and it avoids the subsidy of borrowers by non-borrowers, which has been one effect of inflation-ballooned interest rates.

c. Tax efficient design - As noted earlier, a major problem resulting from inflation is the progressive marginal tax rate on the difference between interest earned and interest assumed in nonforfeiture values. One way to reduce that difference is to include a larger portion of earned interest in the guaranteed part of the contract. Yet this must be done in such a way that the guarantee is not threatening to company solvency when earned rates return to a more normal level, as almost inevitably they must do. This might be done by tying the guarantee to fluctuating index, either inside or outside company experience.

What solutions may be available in the future?

a. What are the product designs of the future?

Perhaps we could rephrase that question and ask if there are any other ways in which life insurance products can be designed to insulate from or accommodate to inflation? Consider some possibilities:

1) Provide a more complete financial service - By increasing the scope of the services provided, a life company may be able better to help the customer adapt to the problems of inflation. This could include a full range of investment opportunities, both fixed and variable. Losses in one area may be offset at least in part by gains in another area.

2) Utilize effective distribution systems - We must seek a mix of systems which provide the maximum level of productivity and job satisfaction. If agents can be more successful and feel a sense of personal satisfaction, the high termination rates could be reduced. This reduces distribution expenses, partially offsetting inflation. Product design, then, must be complementary to such distribution systems.

3) Utilize computers effectively - Until the past decade or two, data processing limitations curtailed the range of choices for product design. With the availability of great computer power at relatively low costs, companies can concentrate on design to meet customer needs in an inflationary economy, with little concern about calculation limitations. Further, product design can assume increasing use of computers by agents and customers and can provide more direct communication with them in many cases.

4) The sum of the preceding points is a set of products which emphasize:

   a) Flexibility at issue to fit the customer's needs.
   b) Adaptability to permit changes in the contract as the customer 's needs change, easily and simply from the agent/

customer perspective.

c) Reduction in costs and ease in meeting inflation-generated changes.

b. What changes are needed in regulation?

1) The basic change needed is to ensure that regulations accept the flexibility and adaptability needed to be more effective in serving the customer. For example, the rules about premium notices may need to be modified to permit a simpler computer interface.

2) Give serious thought to loosening the limitations on life insurance companies in other types of financial services, such as banking - especially if banks are permitted to sell life insurance.

Note: Although the above ideas which accommodate to inflation are important, it is vital that we not give up on a more fundamental effort, to resist inflation directly in every way possible.

MR. ALAN SNYDER: Looking out into the future for new solutions, we really don't require an extension of the direction lines we're already heading in. I think that here will be a broader product line that will be adaptive to change - whether that's indexing, utilization of computers to make most adaptions practically at the point of sale, or activities like that. I think this broader product line though is going to result in insurance companies, securities firms and banks probably all competing directly, if not all in one company, I agree with Wil. I think he's right on the mark when he says utilization of computers. One place where I think the utilization of computers can have great impact is as the delivery mechanism for policies. We have done a fair amount of consumer research in the last three months as to what consumers want in this rapid degree of change. They feel buffeted by the change that they are experiencing. The output of that seems to be a desire for simplicity and convenience. The computer, I think, can directly address those two consumer reactions. Why not give someone the ability to call up on his television set to see how his policy is doing, whatever kind of policy it is. That technology, however, is not as far reaching as it sounds. It's practically deliverable today.

Computers will enable us to take the Central Asset Account or whatever you'd like to call it, and turn it into an open end financial account. Why shouldn't those accounts have a full blown portfolio system, listing all our assets as part of them, giving us the ability to mark our assets to the market and keep track of them as individual consumers? How about, as part of that system, if your're going to capture the cash inflows into it and the cash disbursements (the expenses), why not make it just whatever the insurance agent does a good job doing? Why not turn it into a personal budgeting system, pretty powerful--not so unlikely, either. How about using these kinds of accounts to liquify assets that are currently sitting there? Why not liquify the excess home equity we have? We have seen some attempts with Shearson and Merrill, Lynch to do that. Others will follow. I know there are some insurance companies that are going to offer a product shortly. Imagine the favorable position an insurance company will have by having its products directly tied into this ultimate financial accounting, such that the premiums are automatically deducted from the account, and the product itself is cash buildup or its accounting is directly shown on the statement of record with the regular monthly statement listing everything. Why not, as part of this ultimate financial account, have a user or client data base so he/she can list their assets or registry--key bases that they might want to keep track of, possibly all leading into a living planning system like Connecticut General uses?

But Allan's admonishment to us is that there is a regulatory environment and that does seem to constrain it at the moment. Not having your background, I always seem sort of frustrated when talking to people, because after we start brainstorming a product with an actuary he says, "Alan, it's a terrific idea. I'd love to do that" or "here's another great idea, but the way the reserve laws are structured it can't be done." I say, "Well, it doesn't seem to make sense." They say, "You're right, but we can't do it." I think the reserving and the interest rate assumptions all have to be changed before they really deliver the proper kind of products to consumers. Also, in more of a mundane way, the state by state regulations as you've got larger and larger entities marketing life insurance, become more and more cumbersome. I think there's probably going to have to be some sort of national regulation. I cringe a little bit at the sensitive issue here.

MR. EDRIS: I would like to again concentrate on the flexible products. As you all know, Variable Life is now on the market and it offers several advantages for the client and the company. The client has a choice of alternative investments, and can choose which one best fits his or her investment objectives. The investment choice can be changed at any time, as objectives change. Obviously, the company is protected by shifting much of the investment risk to the buyer.

But variable life is only fully flexible in the area of investments, and the impact that may have on the death benefit and cash value. The product is not flexible in the sense that Universal Life is.

Companies immediately recognized that a wedding of the variable life and Universal Life concepts would result in an extremely attractive product, variable universal life, sometimes referred to as Universal Life II. It didn't take long to realize that major regulatory changes would be needed for the product to be marketed.

It appears that the state Variable Life Insurance Regulations will have to be modified extensively. Work is proceeding through the ALCI on a revised NAIC Variable Life Insurance Model Regulation, with adoption theoretically possible in December, 1982. There is a good chance that the revised model will not be adopted until sometime in 1983. This would push back adoption by most of the states until 1984.

There are multiple, complex SEC issues being addressed, hopefully to obtain exemptions as favorable as apply to Variable Life today. It's probably sufficient for purposes of this discussion to say that it could take several years to resolve all of these SEC issues. There are similar issues to be resolved at the state level with respect to their securities laws.

The tax issues for this product are linked to the broader tax issues facing the life insurance industry. Although no attempt is being made to resolve these issues separately for variable universal life, as broader tax solutions are considered, companies interested in developing this product will work to avoid any unfavorable treatment relative to other products.

Although work on all of these issues is proceeding at a rapid pace, variable universal life is at least two years away from the market place, and possibly much longer.

I would like to make one additonal comment following up on what Wil and Alan have said about the use of computer capability in the field. When we introduced our universal life product, we made the proposal system available through both the Apple and the Radio Shack micro computers. There was a veritable explosion of micro computers in the field, and we didn't pay for any of them. They were all personal purchases by the agent or the agencies. One of the benefits we didn't see when we made that available was the educational benefit that the field received from having the micro computers available on an online stand-alone basis to just play with the product and see what it would do. I'm convinced that we are much closer to significant use of micro computers than a lot of people think.

MR. JACK BRAGG: The topic for this Open Forum is "Individual Life Insurance Product Design Under Conditions of Inflation." I think this topic inevitably leads one to the question of life insurance products which are specifically indexed to the Consumer Price Index or some other similar measure.

At the Society of Actuaries Annual Meeting, held in Atlanta from October 19 to 21, 1981, there was a Panel Discussion on the subject "Indexed Coverages for Individual Contracts." The digest of that Panel has just appeared in the Record -- Volume 7, No. 4.

I moderated that Panel and the panelists were James C. Brooks, Jr., Harold B. Leff, and Richard L. Mucci. The topics discussed were as follows:

1. Philosophical Questions
2. History of Indexed Coverage
3. Possibilities for the Ideal Fully-Indexed Permanent Life Insurance Plan

The panelists did a fine job covering these topics.

It might have been more appropriate if that Panel Discussion had taken place during this special-purpose meeting. Since it was not, however, I hope that those who are interested in the record of this meeting will include the earlier Panel Discussion by reference.

I should perhaps say something briefly here concerning the Ideal Fully-Indexed Permanent Life Insurance Plan. This is a plan under which the death benefits, premiums, and cash and non-forfeiture benefits all escalate with the Index, subject to certain controls. Commissions can also escalate with the Index, and the concept can arise of additional first-year commission whenever the premium increases. The technical manner in which the cash values and reserves are determined, which is known as the Index Accumulation Method, is described in an article in Volume XXII of the Transactions, entitled "Life Insurance Based on the Consumer Price Index".

My main message is that I would like to have the very good work, I didn't do any of this, my three panelists put all of this on last October, and I'd like to have their contributions read into this special purpose meeting we are now having. Thank you. I might also like to point out that here is a present aspect to this, what is now being done and has been done recently and there is a future aspect to it as well. I regard this fully indexed contract as a thing that might be coming in the future, and it is made possible by the 1980 model nonforfeiture law by regulation that has not been possible up until now.

MR. AFFLECK: Wil, is your indexed product offered as a separate product or is it a rider on a current product?

MR. KRAEGEL: It is offered as a rider. It provides a maximum of 8% per year for nine years and we use a method similar to that originated by North American of Toronto in which the premium increases by the same amount as the reserve which is required. In order to put you in a position where you can use the same premium per thousand at the original age of issue, the dividend is used to make up any required reserves, or if the dividend isn't enough then the amount is taken from the cash value of dividend additions which have been accumulated up to that time.

MR. AFFLECK: Alan, how do you feel your stockbrokers selling insurance would react to this product?

MR. SNYDER: I think it's a natural and the only danger that I would see, the concept is terrific and the interest adjustable product is very attractive even if it washes back through, obviously the agent doesn't like the fact that the premium changes; you all would say it would have to if the benefits changed.

The interest adjustable life products that are beginning to come to the market are very exciting. The stockbroker can truly relate to them because it overcomes his greatest critism of whole life insurance. We have been able to, I think, convince the stockbroker that a part of whole life insurance is very appealing for his customers; but he has thrown back that the objection is to the low interest credited and in some cases what he would say "outdated" mortality statistics used. So, I think that if you adjust, not just on interest, but also why not have some adjustment for improvements in mortality. Why shouldn't they be a part of maybe some other kind of index to pass that benefit on to the consumer as well? The stockbroker I said in my opening remarks feels very comfortable in a product that has that kind of adjustability. He likes it. It's part of his milieu. I'm very positive about it. The one caution, I would say, that with experience and indexing some of the annuity products working with different carriers--it was funny, we had a lot of objections, we could hardly find a carrier to index an annuity for us. We finally found a couple that would. The products sold very well, except that there is a danger in locking into an index. You'd better be sure that you find the right index and also say that you may overcredit above the index, if your experience allows you to do that.

MR. EDRIS: I'd like to make one comment on the indexing too. Preceding that comment, I'd like to say that lest anyone get the idea that the Lincoln National has abandoned permanent insurance, that's not true. I talked a lot today about universal life. We do make that available, but we make other products available, too. There are companies that have universal life products that are either working on or have introduced cost of living riders to that product which adjusts the death benefit to some kind of an index. The problem, though, is that it is very difficult within the universal life framework to fully index everything, because of the flexibility in the product.

MR. BILLY JOINER: I just would be interested in knowing what underlying investment you have that makes it possible for you to index a product with the cost of living index. How do you do that? What have you found to buy?

MR. KRAEGEL: I don't believe the investment for this type of product has been considered to be different in our company from other types of investments. It's increasing the face amount, from that time forward the insurance amount has automatically increased. In a sense, it's like a new amount of insurance with face amount, additional face amount, additional premium and the reserve that had to be built up is made up from available funds right there. So, I don't see any particular other, any unusual investment requirement for that.

MR. CLAIR LEWIS: That's clearly a problem when you get into the indexing, the matching of the assets and liabilities. Some companies have minimized that matching by indexing to an investment index like the Oxidental T-bill rate. Life of Virginia, I believe indexes their universal life policy to the higher of the two indexes that are floating bond type of indexes. So, to that extent you can insulate yourself somewhat, but I think it's an additional risk that the companies take when the index is tied to those outside indicators and you just have to do some modeling and become reasonably certain that you've immunized yourself as well as you can from the risks that are involved.

MR. DENIS LORING: The topic here has been life insurance under conditions of inflation and, although we've postulated a scenario of rising interest rates, money in the future being worth a heck of a lot less than money is today, etc., we heard Ashby Bladen in the beginning talking about the fact that maybe the crash is coming, maybe inflation is starting to decelerate and maybe what we will be looking at in the future is a period where conditions might be quite the opposite of what we have now. I think there is a big trap here in that if everything we do is gearing up to operating in today's environment, assuming that environment is going to continue into the indefinite future, are we making provisions just in case it doesn't happen, and are the products that we are developing flexible enough not only for today's and tomorrow's conditions but flexible enough to be able to adapt if those conditions reversed rather dramatically over let's say a three or five-year period.

MR. KRAEGEL: I would just say "Amen" to that. There are a couple of comments where I obliquely alluded to that in my remarks, but I certainly agree that as we determine our solutions they have to take into account going in the other direction. This, I think, is a good sign, although kind of scary, that we are perhaps going on the downhill side of inflation, and if so, we may very well want a panel or special session perhaps in the spring of 1983 in which direction is concentrated on.

MR. EDRIS: I agree completely with Wil. It's something that if we are not thinking about, we all should be thinking about, because it is a possibility. We have some particular concerns about that because of the way the universal life product is being marketed today, where the investment aspects in everybody's marketing campaign clearly are what the agent is pushing. I would think that if we return to periods of "normal" inflation, you would see two things happening. Traditional life insurance would get back into balance with universal life. We wouldn't see the inbalance that we're seeing, at least in my company, right now and that to the extent that universal life is made available to the customer it would be available to the customer for flexibility reasons as much, or maybe more so, than for investment reasons.

MR. AFFLECK: Maybe I could insert a question here. It is a digression from the basic question of insurance product design. We have talked a lot about how securities firms are marketing insurance, and I wonder about the other direction--what is Lincoln doing to market other kinds of products like tax advantaged products, and other investment products?

MR. EDRIS: Before I answer that directly, let me go back and stress a couple of things that I said earlier that may put this into a little more perspective. I have heard in several sessions of this meeting people talk about the differences between distribution systems and the differences between manufacturing systems. I would state as a general hypothesis that while a lot of companies are talking like that, very few are willing to make any kind of a severance at all between those two operations. In general, companies where the distribution system is located tend to feel in their strategic thinking that the products distributed by those distributors must be manufactured by that company. We took the step to separate the two systems 18 months or so ago. We actually have made the leap of fate, saying basically that from a manufacturing point of view, it will be extremely important to stay competitive in the products that you want to make your profits on and to stay viable. You just can't do that on everything that the distributor needs, so that you need to go out and find other outlets and that's exactly what we've done. The process, generally, was approached pretty cautiously because we weren't sure at all how our field would react to it; but we asked them for input on companies that they were using now for business that was going outside of our company and being placed by our agents in other companies.

The only thing that we could really say was that we knew it was a lot, but you really have a lot of trouble getting accurate statistics there. They were quite open with us in telling us who they were using, the kind of products that they were using and we used that as our initial list. We started to contact those companies and we have actually entered into national brokerage arrangements with a variety of companies for both insurance and non-insurance products for tax shelters--oil and gas and those kinds of things, and are making those available now to our agents in such a way that the Lincoln National distribution system also receives some revenue.

MR. AFFLECK: Are these further comments or questions? Are there any other companies in the room who have taken this separation approach to the manufacturing and distribution and are providing products from other companies to their own distribution network?

MR. PAUL LEFEVRE: I'd like to say that it makes me happy to look upon a panel and see two such diverse organizations, both distributing our company's porducts. I feel from our side, the diversity of having the life insurance agent distributing a product as well as a stock brokerage firm, gives us the type of deversity that we feel produces different characteristics in the type of business that they write from a persistency standpoint and from the way they react to various economic situations. I class it similar to diversifying an investment portfolio. I think it's good to have. Thank you.

MR. SNYDER: I would like to add one personal note. We were talking at lunch the other day among the panelists, and I had the benefit of going to some of the meetings, listening to some of you. I said that I was really troubled because I didn't know how I could express properly the pleasure at having an opportunity to spend some time with all of you, without it sounding patronizing. I said that as a group of people, I'd seen you all reacting to a lot of change in incredibly thoughtful ways, with a lot of different approaches offered and thoughtfully debated. My fellow panelists said, "Alan don't be silly, they won't think it's patronizing, we think you really mean it," and I do.