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## SURPLUS DISTRIBUTION AND ALLOCATION FOR NEW AND INFORCE POLICIES

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1. What changes are being made to traditional dividend distribution techniques?
  - Variable loan interest rates
  - Direct recognition of policy loans
  - Investment generation interest rates
2. How are unusual changes in dividend experience factors reflected in surplus distribution?
3. What is the latest experience with policy update programs? What trends have emerged with internal and external replacements?

**MR. ANDREW MUIRHEAD-GOULD:** The first topic on the program is "Changes in Traditional Dividend Techniques" and specifically refers to variable policy loan interest rates, direct recognition of policy loans, and new money interest rates. Mr. Miller will be our lead-off panelist, but I shall start off with a few remarks about the policy loan situation in Canada.

In Canada, we have had variable policy loan provisions since about 1968, but at the time they were first introduced, they were not truly flexible. Agreement was reached with the Federal Superintendent of Insurance, that while the policy loan provision was flexible, a maximum loan rate should be specified in the actual policy loan agreement. The maximum has crept up: at one time it was 9%, then it moved gradually to 12%. It was not until about 1980 that we really moved to a flexible loan rate. The maximum rate that can now be used in Canada is based on the bank prime rate plus 2%. This is a short term index. (Chart #1)

In fact, Canadian companies have not moved to the maximum loan rate. The reasons that we have not are probably twofold. First, the fact that the rate is short term and fluctuates. Second, to my knowledge no major Canadian company has either adopted direct recognition of policy loans in its dividend scales or has moved to a new money interest rate for regular insurance policies.

As long as the loan rate that is charged is higher than the portfolio rate, problems with disintermediation are lessened.

On Chart #2, I compare the Canadian rate that we could charge with the American rate that you are now allowed to charge. The Moody Corporate Bond Index is a longer term rate, and was expected to be comparatively stable.

In the United States, how you are going to cope with the volatility and

Chart #1  
*Canadian Loan Rate Basis*

*Chartered Bank Loan Rate + 2%*

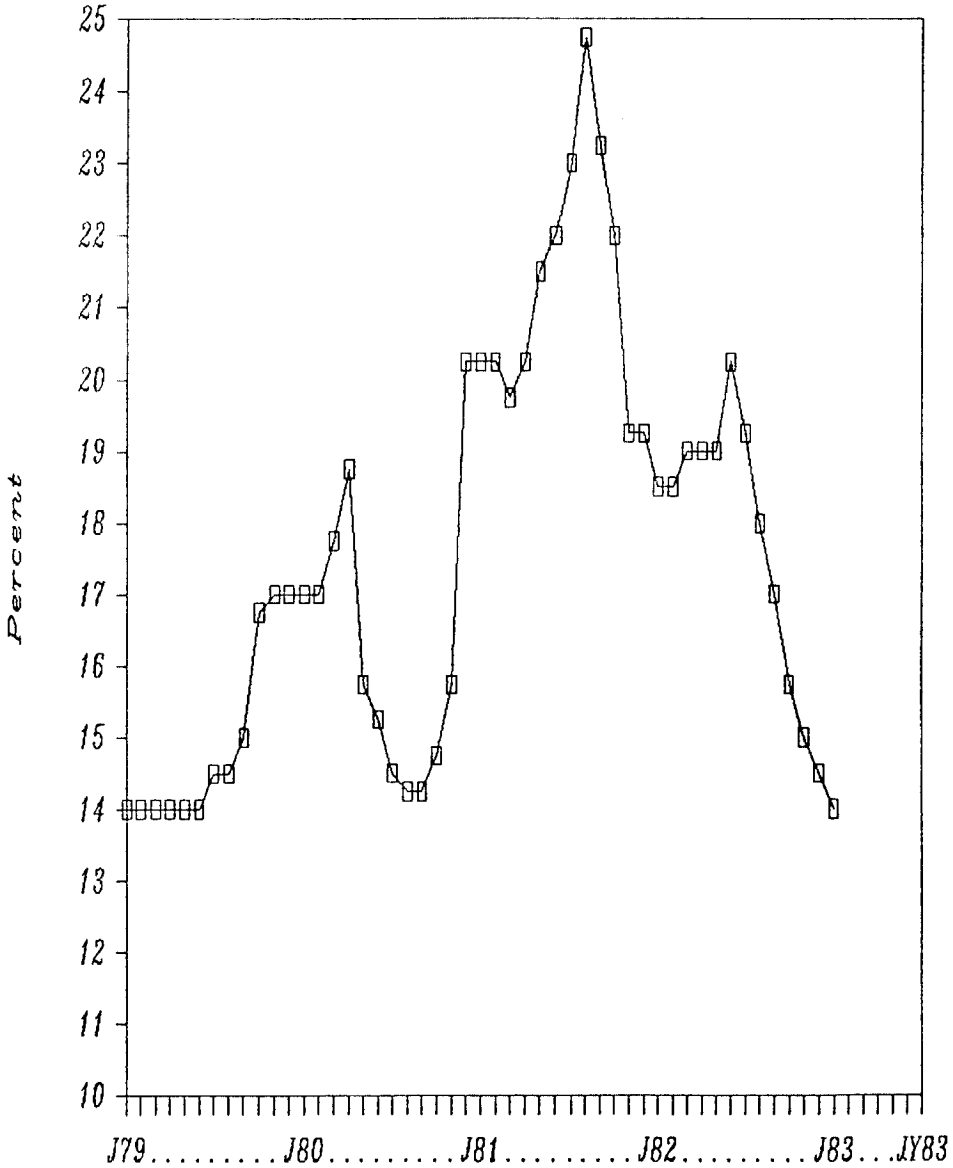
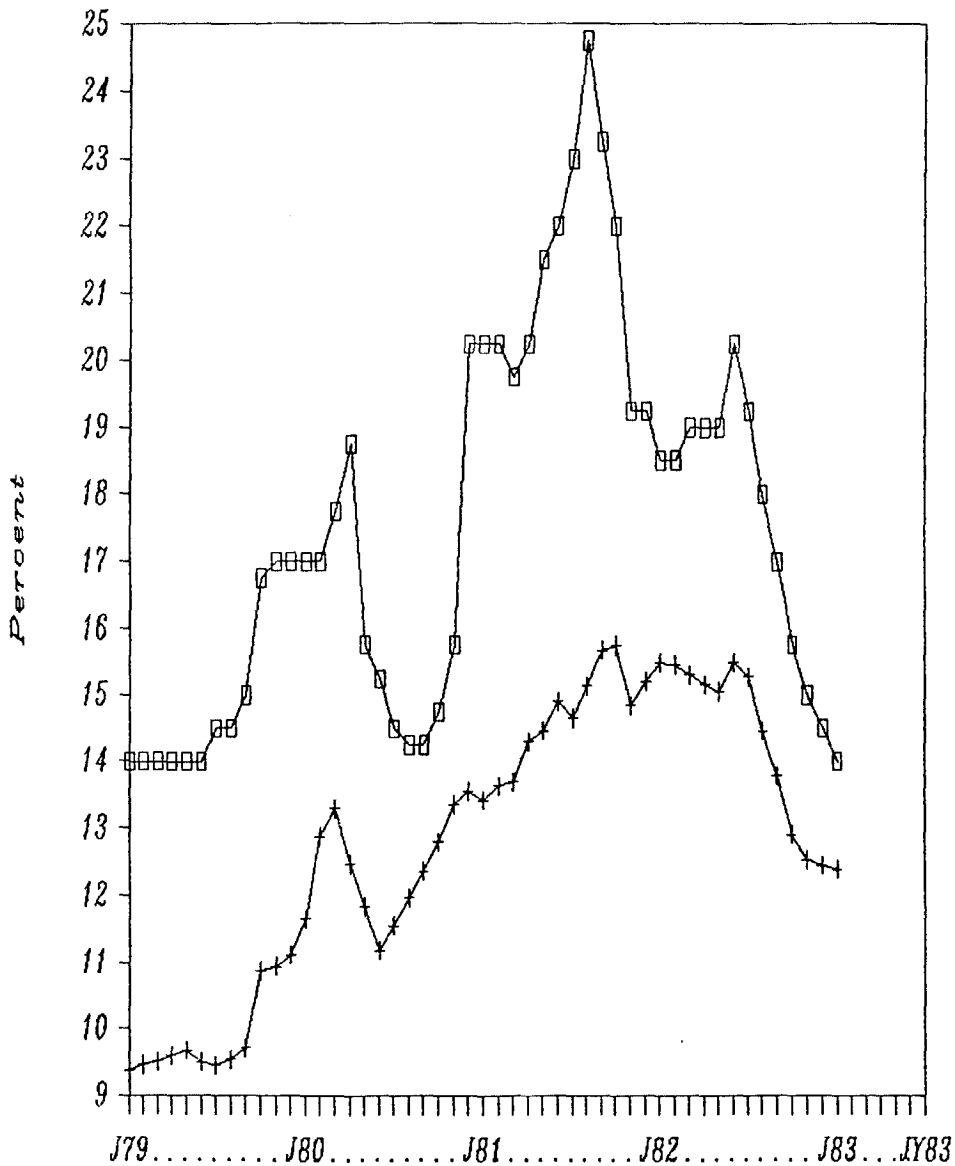


Chart #2

Canadian - US Loan Rate Bases



□ Can. Bank Rate + 2%

+ Moodys Bond Index

the changes that take place if you move to these new money concepts? I wonder whether the changes today are an overreaction to a brief period of high, volatile, interest rates? Do you really believe that the traditional dividend formulas and dividend approaches are no longer viable?

**MR. WALTER MILLER:** First, let me ask you one question about Canada. What is the typical picture for stock companies with regard to loan rates? Have they generally moved to the variable provision?

**MR. MUIRHEAD-GOULD:** My answer would be: yes, they are no different from the mutuals.

**MR. MILLER:** The real question that I would have then is: how do they handle pricing? I would assume that many Canadian companies with variable loan rates will adjust their dividend scale to reflect the least significant change in the level of the loan rate. If that's true, how do the stock companies handle that in the non-dividend department?

**MR. MUIRHEAD-GOULD:** Mr. Rudd, could you comment on that particular point?

**MR. BILL RUDD:** First of all, we do not adjust the dividend scale for fluctuating loan rates because it is just another investment. Non-par products since 1968 generally have been priced such that the policy loan rate will correspond to normal investments. The assumed pricing in Canada has ignored policy loan rates generally, for both par and non-par. Do not forget that stock companies sell very little permanent non-par, they sell mostly permanent par and non-par term.

**MR. MILLER:** I'm going to cover five topics relatively quickly to kick off this part of the program. Some are on the printed program and some of them aren't. The five are: first of all, why are we here?; second, some considerations about new money; third, some considerations relating to policy loan privileges; fourth, some important questions of actuarial responsibilities; and fifth, a topic that I would call apples vs. oranges.

The first point: why are we here? There are two reasons. The first is the widespread recognition in the U.S. of potential problems for companies with low fixed loan interest rates. These problems occur when outside investment yields are high, relative to the fixed loan interest rate. They are the potential for disintermediation, and subsidization of borrowers by non-borrowers to a significant extent.

I will lead in to the second reason why we are here by commenting on the Universal Life session yesterday. At one point in the session, we were presented with a rather shrill sales pitch for the proposition that Universal Life is the absolute and definitive wave of the future, and that traditional permanent insurance is dead. This is just not true.

Traditional permanent insurance is very much alive and has a rosy future, if it is managed to reflect current interest rates in terms of illustrations and actual results as they emerge. This is necessary if traditional products are to hold their own against the new breed of products.

This leads us directly to the next item: new money. Most of us are used to thinking of new money primarily as an allocation question. In terms of some of the things that companies are doing today, it is not necessarily so. I've heard for example that one large company in the U.S. has changed the investments in the entire portfolio backing their individual insurance products, shortening the portfolio's average maturity to two to three years. I've heard that another large mutual company in the U.S. has turned over their entire portfolio so that it may not necessarily be very short, but has all been purchased within the last two or three years, so that they have, in effect, a portfolio of new investments made at a time when yields were very attractive.

These approaches may not be totally problem free and they may not be magic bullet solutions, but they are rather interesting. One thing they do is to make the new money vs portfolio average interest rate question rather academic. Otherwise, in medium to larger size mutual companies in the U.S., it is now the rule rather than the exception to have some sort of new money approach underlying the dividend methodology, and dividend illustrations.

This means that there is: an increased actuarial responsibility with respect to education of management, agents and policyholders; recognition of the additional volatility of some of the new illustrative approaches; new obligations for disclosure, and so on. I will deal with these items later and move to policy loans now.

In the U.S. most mutual companies now use either some sort of variable loan rate approach, or direct recognition for policy loan provisions in new policies. Some companies even offer both, and there may be a developing trend in that direction. Switching over to one of the new loan provisions is also an integral part of many of the update programs I've heard about in the U.S.

Direct recognition. The shortest definition I can give is that on a policy by policy basis, the interest element of the dividend reflects: (a) an assumed company earnings rate on non-loaned assets with respect to the unborrowed portion of the cash value, and (b) the policy loan rate on the borrowed portion, all with appropriate recognition of taxes, etc. It is usually seen with an 8% fixed loan rate, but this is not necessary and there are some policies where the direct recognition concept is coupled with the variable loan rate approach. Let us return to the more common situation where a company has direct recognition and an 8% fixed loan rate. In times like these, where company yields on non-loaned investments are higher, the dividend is lower than what would be paid in the absence of borrowing, and becomes progressively lower with increased levels of borrowing.

This gives rise to one interesting regulatory curiosity. I have seen sales illustrations involving an approach that, after four premiums are paid within the first seven years, adds up to a maximum borrowing approach, some sort of minimum deposit illustration. Then, at the bottom of the illustration, there are some interest adjusted index numbers, calculated on the assumption that there is no borrowing. I would be interested to know if anyone can attach any real significance to what this type of illustration means.

It is possible for the issuing company to say: we have no choice; we are constrained by the law, by solicitation regulations. However, the whole situation is not in the best interest of the prospective purchaser.

In general, the direct recognition approach has these two characteristics. First, it solves the problem of restoring equity between nonborrowers and borrowers. Second, if coupled with an 8% loan rate it may not solve company problems relating to disintermediation when there are significant spikes in outside interest rates.

In any event, if you are worried about disintermediation, you will probably want to pay attention to the variable loan rate approach, as this approaches the disintermediation problem much more directly than direct recognition. There are a lot of systems involving the variable loan rate provision. The most prevalent involves the concept that Mr. Rudd was talking about, that the loan rate would be kept in line with the company's earning rate on non-loaned investments. This solves the equity problem very clearly without direct recognition. You would then use one company interest rate in computing the dividend scale.

One characteristic of this type of scale is its volatility factor, the extent to which a company might think it should be appropriate to change its illustrative dividends. That factor is a lot higher than in the dividend scales we are used to. In fact, that is something that should be recognized but certainly hasn't been to date.

The variable loan rate has another fascinating property on our side of the border where policy loan interest is tax deductible quite freely. There are some criteria that have to be met, but they are not intensive. This property is: for a policyowner in a higher tax bracket than the insurance company, the minimum deposit illustration on an after tax basis will look better as the variable loan rate goes up. Let's take a simple example. A policyholder is in a 50% tax bracket. If the company increases the policy loan interest rate and causes him to pay an extra dollar in interest, this costs him 50 cents on an after tax basis. Under stop-gap, a mutual company wishing to pay out as much investment income as it can in the form of dividends without ending up in the hole is in a 16% tax bracket on the additional investment income. The extra dollar of investment income, which cost the policyholder only 50 cents on an after-tax basis, can be used by the company to trigger an 84-cent increase in dividend. That leverage is really there. For this reason, some companies using the variable loan interest provision have developed products where, contractually, the variable loan rate is always going to be as high as it possibly can be under the governing laws and regulations.

In terms of actuarial responsibility, much of the work that is being done can be defended as logical and necessary in recognition of what is going on around us, and eventually, if properly managed, in the best interest of all the players of the game. Life is more complicated than it used to be, in terms of how traditional participating insurance needs to be managed. This creates a heightened responsibility for the actuary who, after all, is usually the person right in the middle. We have a responsibility to make sure that our management is informed, in every way, about the implications of some of the steps that can be considered, and some of the actions that can be taken. We have a responsibility to agents to make them aware of a number of these implications, because they

are our communication to our policyholders. Let's face it. They are a body of people who are largely still dedicated to the proposition that illustrative dividends are minimum guarantees. But this is no longer true, at least in many of the scenarios that we've been talking about. We have a responsibility to our policyholders to inform and educate in this respect.

Finally, apples and oranges. So far we've been talking about dividend systems and related actions with respect to new issues. What do we do about inforce? We have new issues whose illustrations are geared to some sort of new money approach, reflecting current levels of interest. The sales illustration implicitly involves the assumption that current levels of interest rates are going to continue unchanged many years into the future. In many situations, we are also looking at dividend illustrations for the continuation of inforce policies, which are geared to the portfolio rate approach, and therefore carry the implicit assumption that the portfolio rate is going to continue unchanged. These two things can't happen at the same time. You can't have unchanged new money rates and unchanged portfolio rates co-existing. If the new money rate is going to continue unchanged, then the portfolio rate is going to rise. If the portfolio rate is going to continue unchanged, then the new money rate has to come down.

We continue to put out these apples vs. oranges illustrations. We're misleading our policyholders. We are providing the ammunition to make replacements of inforce policies with new coverage that is not in the policyowner's best interest. I'm not trying to say that no replacement can possibly be good. That is an article of faith that had gone by the boards in the world in which we live. Let me repeat: these apples vs. oranges illustrations are helping to support replacements that are not in the policyholder's best interest.

What can we do about this sort of thing? I've had a lot of people tell me that there is not much we can do, that we are stuck with a body of law and regulation that forces us to continue the treatment we have for future dividend illustrations on inforce policies because of their references to "current conditions". These laws and regulations do not have to be read that way. It's critical for us to move to an apples vs. apples system, where illustrations of new and inforce policies reflect consistent (rather than conflicting) assumptions as to the underlying "new money" vs. "portfolio rates". This change is essential, and actuaries can play an important role in bringing it about. It's more than a question of working things out so that apples vs. apples illustrations are permitted. I would submit to you that there is a responsibility to require that the illustration system be changed so that we have apples vs. apples instead of apples vs. oranges.

With that possibly warm potato, I would be happy to turn the proceedings over.

**MR. MUIRHEAD-GOULD:** Would you like to comment on Mr. Miller's remarks?

**MR. THOMAS SUTTON:** At one point in the dividend philosophy discussion, there was some consideration of how to enunciate a principle that would clearly state that new money presentations for illustrations based on elements that reflected a rate of inflation were acceptable, whereas

other types of projections were not. This becomes very difficult because inflation can be viewed as the difference in a changed situation. It is a rate of change.

If you take the traditional approach that says that illustrations must be based on current experience, it is the portfolio rate that represents current experience. A new money rate may not represent current experience because it includes within it an element that corresponds to inflation.

If you take a theoretical approach that accepts use of a rate of change as the basis of illustration, for the purpose of investment return, then you can easily suggest that you ought to be able to use rate of change in other elements; rates of change in mortality, for example, or expenses.

As it turned out, we never did manage to enunciate a very clear principle in that regard. It is probably just as well because the actual situation has by passed the theory in any case.

**MR. MUIRHEAD-GOULD:** I would like to address a question to Mr. Miller. Disclosure statements clearly state the dividends are illustrated, and you are suggesting that one should start to project dividend scales. Yet we have always said projected scales are not allowed. Are you implying that on new money illustrations, you should say that this is based on projected experience?

**MR. MILLER:** There obviously have to be controls to keep any changes in the present projections from becoming too romantic. This would lead to more problems than you would solve. However, the problems that are created by the present apples and oranges approach are so critical that it is advisable to do some significant breaking of new ground.

The world has changed significantly, whether we like it or not; out there in the marketplace, perception is reality. We all talk about the wording, the footnotes that we put at the bottom of illustrations. But, many more times than not, important financial decisions are made by agents on behalf of their policyowners, or are made by policyowners on their own behalf, strictly on the basis of the numbers without regard to their implications. We have some responsibility to place numbers in these replacement/comparison situations on a basis that is more in the policyowner's best interest, so he can make a better judgement. If it means departing significantly from past principles, then so be it.

**MR. RUDD:** Would the problem go away when the new money rate is below the portfolio average? They are just about equal in Canada now.

**MR. MILLER:** No

**MR. RUDD:** Will there still be companies on a new money assumption?

**MR. MILLER:** The problem might go away if the new money rate from point X henceforward would always equal the average money rate. I think we have to prepare for some other contingencies however.

**MR. SUTTON:** From my point of view, the key feature is sensitivity analysis of pricing. One set of illustration numbers implies, at least



based on past experience, that they do correspond to some kind of a minimum floor that Mr. Miller was referring to. Instead, a logical approach would be to have a range of results, depending on the degree to which emerging experience is tied to the actual situation. That in a sense is what Mr. Miller is suggesting when he mentions using an increasing portfolio rate that is consistent with a given level of current money rate.

A difficulty is that communicating such information to a buyer in some meaningful fashion is almost impossible. Internally, it may be useful, and it may be useful in communicating to your agents a feeling about the range of results that is possible. If you only look at the illustrated scales, two products may appear to be widely divergent in terms of result twenty years from now, but in fact are not all that different if you look at the reasonable range of results for any one of them. But I really do not have much hope for being able to pass that information to a client in a way that is understandable.

**MR. MUIRHEAD-GOULD:** The second topic on the agenda considers unusual changes in dividend experience factors. During the 1950s and 1960s I believe my company increased its dividend scale by 1/10 of a percent each year for 15 consecutive years. Admittedly the increases were quite small. In the last 10 years, increases have not been as regular, but we have managed to avoid decreases, except for a few special adjustments.

Yet, today it seems that many companies could be facing various major discontinuities in their dividend experience factors. These could occur because of:

1. The obvious changes that take place when new money interest rates are recognized;
2. Changes in the basic U.S. tax structure, i.e., stopgap, which could see several years of low taxes followed by a new, but as yet uncertain, tax base.

**MR. SUTTON:** I understand there was hardly any discussion of this specific topic in Chicago, and I am not surprised. When I was preparing for it, I spent some time browsing through the basic sources of conventional dividend wisdom: MacLean and Marshall's texts, Jackson's article, the Society's study materials and a few other items. There were frequent references to continuity, to maintaining expectations, to gradual change and to reflection of emerging trends. There were very few and only cursory allusions to radical shifts and discontinuities. One of the few is MacLean and Marshall, which said:

"where conditions are exceptional or abnormal in any way and are such as have resulted in, or may lead to, more substantial gains or losses in surplus, attention will be given primarily to the amount which should be retained in the general contingency fund, rather than to the cost of any modified dividend scale".

The conditions mentioned in MacLean and Marshall which may require special consideration include: substantial changes in levels of new business, exceptionally rapid changes in interest rates, and uncertainty in regard to the general financial situation. These are all elements with which we are quite familiar.

All of these sources include statements of the basic principles of the safety and integrity of the company. The interest of the policyholders as a whole takes precedence over other considerations.

Taken together, these and similar statements confirm that in abnormal times, attention properly shifts from equity to solvency, from managing the dividend scales per se to managing the surplus funds. In fact, it seems appropriate to go another step and suggest that in times of constrained resources and significant change, the primary concern of management should be: to manage the fundamental assets of the company so as to maximize the expectation of continuing viability and vitality. "Fundamental assets" for this purpose certainly includes surplus but it also includes the blocks of business themselves and their future profit potential, the distribution system; Human Resources; company reputation and even current organizational momentum. All of these elements and many others should be integrated into a strategy for achieving corporate vitality.

What does this have to do with updates, dividend discontinuities, and variable loan rates? Simply that the technical details of approach should be viewed not as ends in themselves, but as tools designed to achieve specific corporate goals. That implies that you have established those corporate goals, and you are not just reacting to approaches taken by other companies. This principle is certainly relevant in considering pricing and product changes prompted by discontinuities.

Discontinuities may occur for an entire block of business, or within a block; they may be imposed from without or be self-induced; and they may be abrupt or gradual. The specific characteristics will affect how you deal with the discontinuity and they will affect the relative emphasis between surplus levels and equity. One example would be a forced unisex pricing basis. I hope it will not be retrospective, and at this point I believe it is unlikely. If you did have legislation mandating a unisex basis for inforce business, it would obviously be abrupt, imposed from without, and it would affect most blocks of business. In that case, the company response must be dictated more by immediate necessity than by strategy. Also the range of actions among companies within the industry is limited, so the details of the techniques selected by a particular company may not have any great competitive impact in a relative sense.

For most business in force, male and female policies differ mainly in the gross premium. There may be some difference in settlement options, but in terms of basic policy pricing, it is simply in the gross premium. The legislation that had been proposed would have required as a practical matter that male premiums be dropped to the female level.

To offset the rather significant reduction in income, most companies would have been compelled to reduce dividends, possibly for each plan and issue age cell, by an amount equal to the premium reduction for males. That straightforward approach maintains rough equity by cell and may result in surplus levels which are acceptable, similar to what would have been obtained without the legislation. One dramatic complication would be the possible generation of huge deficiency reserves. This might impel a company to virtually eliminate dividends for a period of years.

Another response might be to offer policyowners an exchange to a new

unisex plan with premium levels high enough to avoid deficiency reserves, but priced more favourably than the low premium/no dividend version of the existing business. It would be interesting to learn if companies have contingency plans along those lines, or for that matter if the updates that they contemplate have incorporated some kind of unisex change as well.

Another potentially abrupt and imposed dislocation would arise from changes in tax structure as Mr. Muirhead-Gould mentioned. If the changes did not result in an immediate or significant change in the aggregate tax, at least for a particular company, then the discontinuities would occur within a block, due to the implied reallocation of the tax. In that case a gradual program of dividend scale changes could be used to grade into that revised allocation. The usual secular increases in dividends would serve to mask the scale reductions that might be required in some cells.

Another example arises from the use of tax savings, generated by Modco and/or Stopgap. One approach would simply be to reflect the entire reduced level of tax in the current scale, assuming by implication that the reduction is permanent. If dividends had to be decreased in the future due to a tax increase, the company would then blame the adverse action on the government, to the extent that that would help. An alternative approach would be to use the total amount of realized tax savings that had actually gone through your statement to accelerate the effective dates of some future scale increase that could be justified for other purposes. That is, you might first project financial results five years hence, then set an appropriate current dividend scale at that point, relative to your objectives for overall surplus and target annual contributions to surplus. You could then determine the extra cost of introducing that scale now, that is, the difference between the revised scale payout and the amount available if target contributions to surplus are met. The extra amount would then be compared with the tax savings to be released. If similar, you would use the five year period. If not, you would lengthen or shorten it as appropriate.

Another example of dislocation within a block is one that I am reminded of by Mr. Muirhead-Gould's comments, that for a 15 year period, there was an annual 1/10th of a percentage change in the dividend interest rate. I think that many companies over the last 20 years or more have had dividend scale increases which have been rather straightforward, and to which perhaps not a great deal of thought was given at each time of increase. It was simply a matter of reflecting an additional dollar amount available for distribution that arose mainly as the net of an improved interest rate for the company and an increase in expense rate.

The logical and theoretical method would be to increase the dividend interest rate in a manner consistent with the actual rise in interest earnings, and at the same time to incorporate larger expense charges. But to have done that would have resulted in dividend scale decreases in some cells and that seemed undesirable in the view of many companies. As a result, the scale change was made in an aggregate fashion; this was accomplished by holding down the dividend interest rate increase and by not incorporating any increased expense charges.

If you do that over an extended period of time, it is quite possible to

end up with nominal dividend interest rates that are substantially lower than what you would assume to be appropriate, relative to actual conditions. At the same time, expense charges incorporated in the scales would be similarly dislocated. To fix that would require a rather dramatic reallocation of dividend within a given block, and perhaps from block to block. No company has really addressed that particular problem. It may be that update programs of one sort or another are going to be used not only to accomplish the stated objectives, but also to redress these kinds of problems which have accumulated over an extended period of time.

On some of the items that Mr. Miller mentioned, particularly the use of direct recognition and variable loan rates, I would mention that Pacific Mutual has recently introduced a product that was the result of the competitive pressures that have been visible for some period of time. It was the result of a consideration of Universal Life: its popularity, its advantages, its disadvantages, and the observation that the attractive element of Universal Life was the high visible interest rate. The other elements of Universal Life, per se, were less significant, and its introduction for a company of our sort would have required dramatic changes in the way we do business, primarily in the field.

As a result we decided to have a traditional fixed premium, fixed benefit whole life product. The only difference from prior ones, was that there was a visible interest rate. That is, there was an excess interest credit that would be made visible in the product. It would be made in such a way as to separate the interest on the loaned portion of the product from the non-loaned portion, and that for the loaned portion there would be a choice between using a variable loan rate or the 8% fixed loan rate. As an administrative practice, we would permit switching from one to the other.

The primary reason for the variable loan rate is the one that Mr. Miller alluded to. That is, on minimum deposit business, use of the variable loan rate can provide a better after-tax net result to the policyowner than a lower interest rate would.

The agent groups, primarily the NALU and AALU, were originally taken aback by the prospect of a variable loan rate which at the time it was first discussed would have had a maximum substantially above the 8% that they have just recently gotten used to.

However a number of calculations were made by a few of those agents in conjunction with a couple of companies. These calculations were made for a variety of potential products which were not then available, and one of those options included a variable loan rate with direct recognition. The results for a buyer of such potential products was one of the main elements that turned those agents' groups around and obtained their support for the variable loan rate legislation.

Some of our agents were prominent in that operation. It seemed pretty clear that, in order to fulfill their expectations in this regard, we had to have a coupling of the variable loan rate with direct recognition.

MR. MILLER: Let me add to some of the comments Mr. Sutton made on discontinuity, specifically with reference to tax changes. First, I like

his reference to being able to blame the government if things go sour and you have to slash your dividends. It is right in line with Walt Miller's Second Law of Corporate Organization which says that no large corporation can function effectively without a clearly defined scapegoat. That usually works with people, but the government will do just fine.

If there ever was an area where statutory accounting can confuse and mislead you instead of helping your planning, I would submit that this might be one.

Consider what has been a fairly typical case. A mutual company that was taxed on investment income is now taxed under stop-gap on gain from operations, and it uses a modified reserve system and the 818C reserve revaluation formula. In the year after the changeover, on a purely statutory basis, new issues start off with enormous statutory gains in the first year on account of the \$19 to \$21 per thousand allowance.

But issues of the previous five years are probably worse off, at least for a while, on the new basis. That is because investment income builds up relatively slowly in low premium products that have relatively high reserve tax bases for years two through seven or eight. Then the position changes again for issues of eight years ago and prior. They look much better on a gains from operations tax basis. If you look at those figures on a statutory basis, you are going to be in a mess. You have to find some other way of analysing the situation, to try and meet all the criteria.

**MR. WILSON SCOTT:** Mr. Sutton, you raised the question of unisex and retroactivity to enforce policies. You assumed that there is no question that we would have the right to adjust our dividends to reflect this mandatory action on premiums. I have heard a few who wondered if there is any possibility that we could not take up the slack in dividends?

**MR. SUTTON:** I think that is a survival issue. It is rather difficult for me to imagine that the legislation would be retroactive without some ameliorating factors. Because of the financial impact, it is difficult to imagine that this would be the event that would be used to reverse the historical court decisions that have been made to give a company the right to manage its own dividend scales. It is an atom bomb theory. It is so bad that why should we really consider it? Why give it a great deal of thought?

**MR. RICHARD RASIEJ:** I have a comment about the potential reduction of dividends in the light of the possible retroactivity in unisex legislation, which is increasingly less likely. It is worth making the point that if for example, you decide that you would have to reduce premiums by X million dollars, then the reduction in dividend scale is actually X plus a little more. Since you are reducing the dividends, you are also going to be reducing the amount of the investment income that you can funnel into the distributable surplus. Chances are that your expenses and benefits are not going to be similarly reduced, so that your operating gain before taxes and dividends is going to be reduced by more than the amount that your premium income was reduced.

**MR. SUTTON:** Yes, that is true. If you went into the details of it you would have a number of other factors: the expenses associated with the

premiums; any change in the build up of values and the investment income; the fact that if, on a cell by cell basis, you tried to reduce the dividend by an amount equal to the difference in premium you will not be able to do so in early years, because the dividend may not be sufficient.

**MR. MUIRHEAD-GOULD:** The third topic that we are here to discuss is update programs and trends with internal and external replacements. I chaired a Canadian Institute meeting not too long ago in Montreal, where a similar topic was named "Enhancement programs", because the programs adopted in Canada have tended to be unilateral rather than bilateral. Very briefly, I will comment on the situation that we have in Canada. There has been considerable activity lately and the enhancement programs have generally fallen into three different categories.

The first approach is to grant an across-the-board increase in the face amount of coverage for all older inforce policies. By old, I mean prior to 1968 for instance, when we had a change in the policy loan provisions. This approach can also be used for non-participating policies. In one case, the amount of the increase was directly offset by any policy loan outstanding. The concept is simple, and the benefit to the policyholder is reasonably clear. It provides more insurance coverage per dollar of premium, and the result should be improved persistency. The funding, the justification for the program, is usually that in the long term, improved persistency will pay for the benefit.

The second approach that has been used quite frequently in Canada is again quite simple: a unilateral change in the basis used to calculate paid-up additions by moving to a higher interest rate or lighter mortality. You can immediately increase the amount of paid-up additions for both existing bonuses and future purchases. It costs very little, but it does nothing for policyholders who do not have the paid-up addition option.

The third approach is very interesting. There seems to be a move toward payment of termination dividends. Some of the British companies that operate in Canada have had terminal bonuses, but none of the Canadian companies had adopted this approach until the last year or two. It is certainly an incentive for improved persistency. I am surprised it has not been mentioned in any of these update discussions.

**MR. MILLER:** A termination dividend will pay you more when you cash in your policy or otherwise terminate it. Why is that an incentive for improved persistency?

**MR. MUIRHEAD-GOULD:** If you have to keep the policy for 20 years, it certainly improves persistency in the early durations. What happens at the end of the 20th year is hard to say.

**MR. SCOTT:** Is not there something different in Canada? If you introduce a terminal dividend, it does not have to apply to surrenders?

**MR. MUIRHEAD-GOULD:** That is true. You can provide termination dividends that apply on death or maturity but not on cash surrender. That is the approach that is normally followed in Great Britain. I find it hard to accept the fact that a policy that matures gets a terminal dividend, but a policyholder who surrenders a few years prior to maturity

gets nothing.

Mr. Scott, Massachusetts Mutual has just completed a major update program, and I wonder if you could take over now.

MR. SCOTT: This program had a twin counterpart in Chicago. This presentation is a duplicate of Mr. Tom Leary's presentation.

Mr. Miller has already mentioned the problems of disintermediation with fixed interest rates at 5%, 6%, and 8%. We were very bothered by that in 1980-81. We were bothered too by the fact that the borrowers are subsidized by the non-borrowers. Mr. Miller did not mention lost investment opportunities, but borrowing was keeping our non-loaned portfolio yield down altogether too low.

To emphasize the extent of disintermediation, in the period of 1980 and 1981 for the life companies in the U. S. in general, the increase in loans outstanding increased from \$35 billion to \$49 billion, a 40% increase. Our increase, if anything, was a little bigger than that. The result for many of us was not only the increasing amount of policy loans but also the lost investment opportunity I have mentioned. It was necessary to liquidate investments or divert current cash flow to meet policy loan and surrender requirements, rather than investing new cash flow at higher rates. The other problem was the effect of the onerous phase 1 of the 1959 Tax Act. To emphasize the combined effects, in 1981 the overall earnings rate for life insurance companies was a magnificent 8.53%. For a company like ours, that was in a 40% marginal tax rate on investment income, we had 5.1% left to distribute to the policyholder. At that very time, new products such as universal life were on the market with illustrations that had double digit rates extending into the future. The availability and increasing importance of money market funds also caused worries about cash fallout. In fact, surrenders increased in volume and the amount of replacement activity picked up significantly. Lapses and surrenders for the industry increased from 7.2% to 8.9% over the same two years, 1980 and 1981.

In reaction to the cash flow problems that were created many of us started to consider various alternatives and strategies. At Mass. Mutual we felt the problems were serious enough that our long term survival was possibly threatened. There was increasing pressure at the home office and from the field to develop both traditional and non-traditional products to meet the competition. We had a further determination to conserve our inforce and to retain the agency system as our primary method of distribution. Consideration was given to adopting investment year allocation method (IYM) but we concluded that a portfolio approach was really much better for our particular situation.

Our positive concern in this regard was equity between new and old policyholders. The negative one was that we did not want the acceleration of replacements that we thought would be attendant on going to IYM. As a result of our revised company strategies, we decided to improve our product development and financial services actuarial staff.

We embarked on a program to develop and implement new traditional products, non-traditional products and an update program for our inforce. It began with a new 8300 series of policies for new issues

which was introduced in January 1 of this year. It featured an adjustable loan rate provision (ALR) and a single dividend scale, whether the policy was borrowed or non-borrowed. We made this available in all states that had ALR legally available, and somewhat reluctantly used the direct recognition approach in the other states. We will switch the direct recognition states to ALR as soon as the law allows us to.

We feel that ALR provides the best policy loan solution for us, although we realize that others have and will choose differently. We have sold a significant part of our business on a minimum deposit basis; ALR seems better suited for this type of business. ALR certainly provides the best answer to the continuing problem of disintermediation as interest rates fluctuate.

Having decided that ALR was the best course for our current issues, we updated the inforce business where permissible by giving the policyholder the chance to replace his current fixed loan provision with an ALR clause.

We did consider a dual dividend approach for the inforce, but we wanted the parallelism between new issues and inforce. We may yet offer a dual dividend in states where the update to ALR cannot be made available. I will come back to that.

The update program for us was developed during the spring and summer of 1982 and implementation started in August of 1982. Our update project team was headed by a Senior Vice President from the Policyholder Service Division. Key personnel from Agency, Policyholder Service, New Business, and Personnel Divisions were diverted full time as required. A particular date in this process was November 5, 1982, when we held a national three hour video conference for more than 4,000 agents and general agents. Our president and a number of other top management personnel carefully reviewed the program with the agents by that tele-conference.

The implementation of the update program is a large job because there are some 80,000 policies per month that are eligible for update. It started in January of this year when we sent update offers to March anniversaries and will continue on a monthly cycle until we have reached February anniversaries in 1984. The policyholder may elect update directly by mailing right back to us, but really he needs the services of an agent. This was to honour the wishes of our field to be involved in this process. For the borrower it is almost a necessity. If the agent procures consent for an update, we pay \$25.00 for each policy. We have New York approval for that process. We plan on a second phase, beginning in March of 1984, when we will deal directly with the non-updated policies to give them another chance.

The results so far, with only two months behind us, show approximately 50% of our non-loaned values have moved to the update provision, somewhat less than 20% of our loaned values. I would say the latter is pretty close to expectation. I am personally disappointed at the 50% ratio so far for the non-borrowers.

**MR. MILLER:** Do you have a particular explanation as to why that number is so low?



MR. SCOTT: My answer would be less than total field force participation. It is about as easy to get the field going in another direction, that is, updating rather than selling insurance, as it is to turn an aircraft carrier quickly to another course. We expect better things.

MR. MILLER: Did you ever give any serious considerations to the Book of the Month Club or negative consent approach? That is, you will be updated if you do not tell us "no" within a certain period?

MR. SCOTT: We give it consideration, I would say not serious.

MR. MILLER: We are considering taking all our inforce policies with the dividend deposit option (in New York Life that is a much larger percentage than in most other companies), and giving them a chance to convert outstanding deposits to paid-up additions without charge and, without evidence of insurability. We had a lot of discussion about negative consent, and we ended up with the same conclusion that you did, but reluctantly. The results that you will get are probably going to be so much better with negative consent. But there are a lot of things that worry you about it.

MR. SUTTON: I would think that anything that would result in, even for a limited number of people, any disadvantage at all would come back to haunt you. It could be served as a basis for a class action suit.

MR. SCOTT: I have talked about Life Insurance, now on to annuities: accumulation annuities, flexible deposit annuities, etc. Annuities that we have been offering for the last several years have not included a loan clause. The update process for existing annuities is to remove the loan clause for those that do have a loan clause. For that, we do not compensate the agent.

I will now return to the legal situation in various states. As of last week, we have no ALR law in sight in five jurisdictions: the District of Columbia, Kentucky, Maryland, Montana and South Carolina. The law is in sight in New Hampshire, Minnesota, Mississippi. In all of these states our currently sold product is on a direct recognition basis. We expect to move to an ALR product in the foreseeable future. We have three states that have an ALR law, where we do not have an update program. One of these is Ohio, where the law does not accommodate to an update program, and that was very specific in its enactment. Actually we obtained approval for our update program in Ohio, but we thought it best not to use it. In two more states, we have neither an update, nor do we use ALR for new issues: Iowa and Arkansas. Adjustable loans are possible there but the loan rate is not determined to our satisfaction at this point in time.

MR. MILLER: This specific problem in Arkansas I know is that they have an overriding constitutional 10% limit. There is also a similar law in effect in Texas but the number is 15% so that people generally are not so worried about that. Another problem state when it comes to ALR legislation is Tennessee, which will only permit you to change the rate once a year.

MR. SCOTT: We only change our rate on the policy anniversary, and I

think that means twelve times a year, but only once for any particular policy. Now there is a negative side to an update such as ours, but I do not want to go through it. Mr. Joe Belth has outlined certain concerns he has in his May 1983 issue of the Insurance Forum.

We keep track, as best we can, with what other mutual companies that we compare ourselves with are doing. Northwestern was the originator of updates and we take our hat off to them. Six of the seventeen we compare with have performed or planned a valuation basis update. Two have performed or planned an update to direct recognition. One other plans an update to ALR, and four are thinking about it. I frankly have not heard of any plans in non-par companies, and if anybody can help us in that regard, I think all of us would appreciate it.

**MR. WILLIAM SNELL:** We at Northwestern Mutual went to direct recognition in 1982 for New Issues and started in November 1982 to update inforce policies to direct recognition. Our experience to date is about 58% of all policies, whether they have loans or not, are amending. The non-loaned figure is about 70%. For those policies that have over 85% of the cash value loaned, we get only 20%.

**MR. SCOTT:** Do you deal directly with the policyholder?

**MR. SNELL:** We mail directly to the policyholder. We mail in advance to the agent, so he will know what the offer looks like. He can go out and call if he wants to, but he does not have to. The policyholder has a toll-free line to call and ask questions, and the acceptance is mailed back. It is a bilateral change; we must obtain a return from him.

**MR. SUTTON:** Do you have any clear-cut evidence that persistency has improved?

**MR. SNELL:** No, but we have noticed that policy loan repayments have increased drastically. Policy loan repayments are exceeding new policy loans.

**MR. MILLER:** Let me mention one other interesting situation. It appears that the New York Insurance Department refuses to approve an update program that involves a change in the loan provision, to the extent that one company actually sued them. Does anybody have information on that?

**MR. SNELL:** It was not my company, but my understanding in the New York situation was that it was a tie-in. There was a combination of update of the cash value and the policy loan provision. What New York objected to was the fact that you could not change your cash value basis from whatever you had to, for example, 4% or 4 1/2%, unless you also changed the policy loan provision to 8%. They objected to the tie-in basis, not to the loan amendment.

We have an amendment program to 8% in New York which they did not object to. They will allow you to adopt direct recognition and not change your loan rate. As well, they will let you change from 5% to 8% with direct recognition, if the policyholder agrees to it, but they also want to give him the right to refuse the tie-in, to stay at 5% with direct recognition.

MR. SUTTON: I have a question that relates to discussions that we have had with our field force concerning update programs. The impetus for us to consider an update program might have arisen eventually from considerations of policyowner value, to take some affirmative action ourselves to change lapse rates. The greater motivation however has come from the field. They want us to do something, particularly about business that has been issued in the last five years, to improve the situation for the policyowners.

One criteria that they set down, which the AALU product committee may eventually endorse as part of their policy, is that, from a prospective basis, the policyowner should be better off after an update, than if he were to buy a new product from the same company. One basic question is whether that is possible.

Aside from that, in making such a change, our agents, and for that matter the AALU product committee also, would suggest or demand a level of compensation that might be as high as half of the normal first year commission, perhaps 25% or 30%, rather than what Massachusetts Mutual is paying, \$25.00 per policy. The reaction of our agents to a \$25.00 payment for them to assist the policyowner on update is rather dramatically negative. It is so negative that one has the distinct impression that, if we were to offer a \$25.00 payment, they would deliberately move the business elsewhere, rather than take advantage of the update internally. To what extent have Massachusetts Mutual or any others had a similar reaction?

MR. SCOTT: I am not aware of any hard objection to it, but we have some agents who are not doing the job. With our CEO and all of the top level people so firmly behind it, it would be a pretty gutsy agent that would object. Our agency vice president, speaking for our field force, was willing to go ahead with our update very definitely, even if we could not obtain permission for compensation from New York. The theory was that it was a great door opener, an opportunity to make sales. On top of that fact, they do want us to do the best possible job for their customers. By the way, we are one of the hardest companies on replacements. Basically, we pay no commission on a replacement, except in the case of permanent replacing term. We have Universal Life for sale, but we still think our future is traditional life insurance.

MR. SUTTON: One of my concerns about update programs is simply that they are often predicated upon an improved persistency rate, which in fact, may be questionable by itself. The persistency improvement has to be present and continued for an extended period of time in order to balance any considerations. What is next? Three years from now, what will the product be that every one is interested in, and desires to be updated to? Will it be a kind of multi-fund registered product for example? The concern is, if you do have an update, how long will it be before you are required to have another one and, by definition, not gain the advantage of the continued persistency on the product which you updated in the first place?

MR. SNELL: To answer on Mr. Sutton's earlier question, we have always put a large amount of advertising in our update programs and to that extent, it provides a door opener to the agent. Our company name is more recognizable by the consumer. We have never paid any commissions. We

have never had any objections from our agents, who are all career agents, and supposedly sell only for us.

We see no replacement problems. We have had a tradition going way back of trying to make what is available on new products retroactive to inforce policies. If we can do it by Board of Trustees action, we will do it that way. If on the other hand, it requires communication with the policyowner, we will communicate it and have a bilateral program.

Back when you had to report interest on 1099's on dividend accumulations we permitted the policies that had accumulations to go to paid-up additions. When we have liberalized waiver benefits, we have made that retroactive, and of course, there you do not have to communicate. We do communicate with every policyholder every year and we will tell them when we send out their proxy statement. It gives an agent a better chance to get in and talk to his prospects, and make it easier to sell new insurance.

**MR. MILLER:** Are you committed to adding the multi-funding facilities to all your inforce policies when you do it for new ones?

**MR. SNELL:** It depends how it comes about. If it is multi-funding variable life, it is more complicated. There are Securities and Exchange Commission regulations. We do have it in a variable annuity area and it is very popular.

As to a comment you made before about market rate loan rates, our agents like to sell bank loan minimum deposits now, where the loan is made with the bank at whatever the bank is charging, maybe 12% or 14%, and they use our dividends on a non-loaned basis.

**MR. JOHN HARDING:** I would like to bring your attention to our update program which is so different from what Mr. Scott has described. It would be worthwhile outlining some of the differences. We are starting it in July and we intend to run it over a 12 month period. We decided not to work with the policy loan rate or with direct recognition on the inforce, primarily because one place where National Life leads the industry is in policy loans. For our 5% loan series, over 60% of cash values are loaned out. Instead, our update took the form of an increase in the face amount.

We are using a passive consent approach, unilateral vs. bilateral. We are doing so because we are not making any downward changes in guarantees. We are specifically checking to make sure that every cash value is at least as large as the pre-update cash value and we are also making a very smooth transition in dividends. Another difference would be that we are allowing an agent to opt into the process. If an agent wants to, he can get an illustration 90 days before the policy anniversary. If he gets back to us within the next 60 days with a yes or no, then he is involved in the process. If we hear nothing, then we go direct to the policyholder.

Coupled with that, instead of paying \$25.00 a policy, we are offering an additional purchase on a guaranteed issue basis as a function of the amount of the update increase, and we are compensating the agent in that way. If he can get the extra sale, he will then benefit from that

commission. We expected that would be a cheaper price, in terms of the mortality anti-selection, than paying direct update compensation.

Another thing Mr. Miller mentioned earlier, was the question on any update program of what tax environment are you looking at, and what the effect of that tax environment is this year and next. Our position will be one where, even if we were to revert to phase one, which is a very unlikely situation now, we would have no dividend scale change for the updated policies.

We are building three contingencies into our update. Recently there was a rumor that the Treasury will attack unilateral changes in an update program, that they will not give the same tax treatment as with bilateral. We are in a position where, if they do that, we can change our practice within 60 days.

The second contingency is that once we know our 1984 tax environment, assuming we know it before December 1983, we can collapse the balance of the update into 1984, if it makes sense to do so.

The third that we worked on is accommodating to unisex in the update. We could still pull out and do so quite quickly.

**MR. MILLER:** Are you able to be a little more specific on the rumor, in terms of exactly what the Treasury might want to do to the unilateral update?

**MR. HARDING:** If you use a unilateral update, the process would be looked at as a dividend to the policyholder.

One other thing with respect to lapses: last summer we instituted a program where we would contact any policyholder who gave indication that he was about to surrender or lapse his policy. If that policy was going to be a part of our update program, we would send a letter when we got a cash value request, a letter with a toll-free number for return calls. We have tracked the results, and at this point over 40% of those contacted in that way are still in force.

**MR. MUIRHEAD-GOULD:** Closes session

