RECORD OF SOCIETY OF ACTUARIES
1982 VOL. 8 NO. 4

CONSERVATION STRATEGIES FOR PERMANENT AND TERM INSURANCE

Moderator: JOHN B. YANKO. Panelists: RICHARD A. BURROWS, DALE R. GUSTAFSON, ROBERT D. SHAPIRO

What has been/will be the impact on in-force business from new products and cost methods (e.g., continuous reduction in ART rates, non-smoker discounts, universal life, increased policy loans, replacements, lapses, surrenders and exchanges)?

How have companies responded? Should stock and mutual companies extend new cost methods to existing policyholders? Field compensation when replacing existing business; internal conservation functions; update programs; policyholder/agent communication strategies; new products and their applicability to in-force policyholders.

What "interest groups" must be considered and are there differences when considering a stock vs. mutual company? Policyholder; agent/broker; management; stockholders; prospective policyholder; legal/regulatory issues (IRS, SEC, state insurance departments).

What are appropriate financial considerations and anticipated results? Is "stonewalling" a viable alternative? GAAP effects; statutory effects; use of reinsurance; field force compensation/survival; anticipated future mortality results; Federal Income Taxes.

MR. JOHN B. YANKO: The title and suggested topics should be meaningful to all. Most of us have spent significant time addressing and analyzing lapses, surrenders, exchanges and replacements. The impact, financial concern and possible solutions may differ between mutual and stock companies, however, it is a common concern.

I recently talked with the actuary for a medium sized mutual company who concluded they could not financially justify an "update" program because of TEFRA - the 1982 Tax Equity and Fiscal Responsibility Act. This same company introduced a select and ultimate preferred risk policy (non-smoker and build) in 1982 and offered a 20% discount for similarly qualified business issued since 1981. Their dividend scale reflects policy loan experience by plan or plan groups but does <u>not</u> differentiate the policy loans by individual.

A stock life insurance company actuary said his company had analyzed their in-force business several times and concluded they cannot financially justify an "update" or exchange/replacement program. What they have done is to liberalize their exchange/replacement/rewrite procedures. They will pay additional or modified commissions for such changes. There is significant activity, concern and confusion in the evolving strategies for permanent and term insurance conservation.

This morning we have three speakers who will share their experience and perspectives. We shall hear from a consultant, a stock company actuary and a mutual company actuary. I shall introduce all three speakers in the sequence they will speak.

Our first speaker is Robert D. Shapiro, Vice President of Towers, Perrin, Forster and Crosby and Director of its Life Insurance Consulting practice. Bob is a Fellow of the Society of Actuaries, a Chartered Life Underwriter and has worked extensively for the life insurance industry in such areas as strategic planning and projections, marketing planning, new product design and development, operations, appraisals and diversification/acquisition analysis.

Rich Burrows is Vice President and Actuary with Philadelphia Life Insurance Company which is owned by Tenneco. Rich is an FSA and has experience with both stock and mutual companies and also Blue Cross of New York.

Our final speaker is Dale R. Gustafson, Vice President and Actuary for Northwestern Mutual Life Insurance Company. Dale is responsible for the general direction for the Actuarial Department; is an FSA; worked for the ACLI; is past president of the American Academy of Actuaries and has experience with both stock and mutual companies.

MR. ROBERT D. SHAPIRO: My role on this panel is to provide an overview of the key issues, factors, and decisions involved in developing and maintaining conservation strategies.

Existing blocks of business have been placed under increasing pressure as a result of a broad number of factors, including economic conditions, competitor activity, and emerging new product characteristics (e.g., reducing ART rates and the proliferation of non-smoker discounts and current interest products).

The end result of these factors, and the major reasons for intensifying conservation concerns is worsening persistency, both at the policyholder and at the distributor levels. This persistency deterioration, manifested as increasing policy loans, replacement and lapse experience, reflects fundamental changes in the environment within which life insurers work. Shaking of our "industry fundamentals" has moved "conservation" from just another company function to a major industry issue. All types of companies (large and small, stock and mutual, old and new) are worried about conserving existing in-force business and existing agents.

Examples of existing conservation programs are many, including in-force enhancement, policy loan provision modification, development of specific internal replacement programs, stronger agent persistency incentives, and increased policyholder communications.

How should a company approach its conservation strategy? What conservation activities are right for it? The remainder of this presentation will outline a strategic process that can be followed in answering these questions.

To begin with, a company must ask itself three questions:

- What specifically is going wrong and where is it going wrong?
- How do we balance our short-term pressures for a "quick fix" with the long-term need to build and maintain a totally healthy company?
- How much risk are we willing to take in terms of solving our conservation problems?

Since many of the reasons for the current problems are fundamental, there is a tremendous danger in any band-aid approach to conservation. A holistic approach, one which seeks to develop and maintain the long-term health of the insurance company, has much to be preferred over a short-term symptom-treatment approach. To the extent that symptoms only represent manifestations of broader problems, the band-aid will quickly become inadequate. Often, the patching equipment brought in to cover the symptom creates new damage of its own. Most important, there is a point at which the combination of various short-term fixes eventually produces permanent blockage, and appropriate long-term actions are precluded in the future.

A simple example of the danger of a band-aid approach is evidenced in some life insurance companies that have used cash flow on new business to fund the interest requirements on older segments. The short-term result is that the older segments are indeed more persistent. However, the "increased value" of the existing segment is precisely offset by the immediate loss on the new segments of business that has funded the "adjustment". As important, the internal management of both segments of business is now distorted to the point where appropriate future actions are difficult to take.

Assuming that a company's management wants to take a holistic approach to conservation, the first step is to take a broader view of its situation, and at least pose these questions:

1. How does our company's conservation situation fit within the broader question of how we must effectively manage our life insurance company in the 1980's?

2. What is the appropriate way to analyze conservation within the framework of our changing mission, objectives, strategies, and future organizational changes? For example, a company with a full-financial service mission will require a different conservation approach than one with a desired long-term image of becoming a low cost protection provider.

Once these broader issues are fully considered, the more obvious questions can be addressed, such as:

What are the causes of the changes from traditional patterns of lapse, replacement, and loan, both within the industry and within our company?

How is our company situation similar to and different from generalized industry patterns?

What are vulnerable areas in our company... e.g.,

- policies with large face amounts?
- policies with large cash values?
- policies with policy loans?
- policyholders who have recently gone through a major life status change?
- orphaned policies?
- customers who hold two or more policies with the company?
- short duration term policies?

Which of the vulnerable segments noted above within our company create the most potential adverse financial impact?

How might/can the significant vulnerable areas be effectively controlled and/or managed?

Once the conservation issues have been analyzed in both the broader sense and in the microscopic sense, the appropriate conservation program action steps can be identified and prioritized. A program for monitoring conservation results should also be established, so that the chosen conservation program can be modified as changes in strategic direction or other feedback demand.

Each company ultimately establishes its own set of conservation objectives. They often include one or more of the following: minimize taxes, streamline administration, create customer accounts, provide a marketing tool, portray a progressive image, reduce loan impact, improve persistency, and preserve existing values. The particular conservation objectives of each company must be prioritized within long term company objectives and strategies regarding targeted markets, distribution systems and market needs.

In fine-tuning the long term conservation programs, management will encounter a number of uncertainties and risks. Of major importance is the potential risk of policyholder and/or agent sensitivity. Any conservation program must be carefully evaluated (through market research, focus groups, etc.) to assure optimal acceptance by both the customers and the field force. Depending on the breadth and design of the program, other issues such as potential premium or federal income tax implications, possible capital loss incurrals, regulatory constraints, adverse GAAP earnings impact, and class action suits must be considered.

In the final analysis, conservation programs should support strategy, in the same vein as productivity improvement or expense reduction programs must support strategy. The programs must be carefully linked to the company's long term vision. Often short term results must be compromised somewhat for the benefit of the long term plans of the company.

In establishing and aligning conservation programs within the structure of the company, great care should be taken to assure that the real objectives of conservation are understood and not masked by public rhetoric of the company. Often the real objectives are considerably different from those that are publicly stated.

Avoid fretting over things we really cannot manage or becoming paralyzed by segments of business that we have written in the past. Identify what is controllable and through careful analysis of the situation, change what can be changed; accept the necessary losses, and move forward! Focus on the future solidity of the company; life insurance companies quickly "become what they write" (at least the successful ones). A successful conservation program will mirror the long term mission of the company. It will be broadly focused, encompassing future as well as existing policies/policyholders and distributors. It will be sensitive to the needs and wants of policyholders and targeted markets. The program will be designed to maintain the health of the company, instead of merely bringing down the current fever, and will be carefully matched against the organization's capabilities to assure implementation success.

Finally, the conservation program should be established to create several immediate successes. The enthusiasm of the organization so critical to the long term success of a holistic conservation program will be assured by the confidence created by a successful introduction!

We may have to accept some loss from what we expected (hoped for?) years ago. Conditions have changed; this is one of the risks we accepted when we originally wrote our business. Fortunately, we have won more than we have lost in the past! A strategy linked, holistic approach to conservation will position us to continue to be net winners in the future.

MR. RICHARD A. BURROWS: What is it we want to conserve? My first reaction to this subject was that we wanted to conserve the old policies. Of course we do, if we could find a way to do it and thereby we would maintain cash flow and avoid capital losses. We would then enjoy the higher profit that we had assumed years ago. If successful, we could be satisfied that we were keeping the promise of continued protection at a guaranteed cost that we made originally. But, would we be dealing fairly with the policyholder?

My initial reaction gave way to the idea that what we really want to conserve is our agency force and our policyholders, but not necessarily the policies. I am here to represent stock insurance companies, but I will not claim to give a complete representation of all stock life companies. I will try to state what Philadelphia Life is doing to respond to the very dynamic milieu that we find ourselves a part of.

Philadelphia Life markets through personal producing general agents and through brokers. With such a marketing design we are very, very product oriented. To conserve policyholders and agents, we have developed products. In 1979, we came up with an adjustable premium, otherwise known as an indeterminate premium, whole life product. The following year we came up with a second version of that same product. In 1981, we introduced an annually renewable five year revertible term product and through this vehicle we introduced our non-smoker rates for the first time. As a result, our 1981 volume was 120% greater than our 1980 volume, but I do not think our agents were all that happy. Our first year premiums were only up 25%. This year we started selling the universal life plan. We are currently in all states except New York, where we do not operate. Although the momentum is just beginning to pick up, we are finding that 30% of our new premium is on this plan and its average premium per $1,000 is around $14.00 as compared to around $5.00 per $1,000 on the remainder of our new sales. This will make our agents happy. They can make a reasonable sale and earn a decent living.

Bob has said that conservation has to be a total company approach and I wholeheartedly agree. I believe that conservation for a product oriented stock company consists of three parts.

1. The company has products that are market responsive. We at Philadelphia Life have an ART and the universal life plan.

2. The company should have a program to allow policyholders to transfer existing plans to these new products. It may want to encourage the transfer. We are not, and perhaps many others are not, in that comfortable position, but the situation should be such that if you are going to lose the business, lose it to yourself. We allow the policyholder to roll over cash values on existing plans to the universal life form load free and not commissioned.

3. The third part of the program is an internal management plan which recognizes the realities and makes the transition as smoothly as possible.

Salable new products are needed to keep your agency force. If you have an agency force that you think is yours, maybe a little research would show that it is not as entirely yours as you would like. But salable products give them something that they can sell in the current dynamic environment.

Policyholders are demanding more from stock companies than the original promise of guaranteed cost. They want to participate in the current experience to the extent that current experience is to their benefit. Management wants to keep the company together... sales, policyholders and capital.

How have companies responded? They responded with these new products. They have recognized that the marketing system must be maintained even if they also know that completely loyal agents are a thing of the past.

How can they treat existing policyholders? Northwestern Mutual's update program very definitely addresses old policyholders. Should stock companies try to do something similar and grant broad premium abatements to all blocks of business? This would certainly be in line with the philosophy of adjustable premium policies. I do not know of any stock company that has done this. But if interest rates return to their high level, it may have to come about. I suspect that most companies have made first year commission adjustments on replacing products. Compensation on replacements to our two new products involves reduced commissions over the first five years after issue of the new plan. On the cash value roll over into our universal plan, we do not pay commissions. Thus, we try to save some cost without forcing the agent to place this policy elsewhere. When your agent places an existing policy elsewhere, there is an erosion that occurs if he feels he is forced to do that. Then it is easier a second time and still easier the third time. Soon you really cannot call him your agent anymore.

On the subject of internal conservation functions, I spoke with six companies that had programs somewhat along the traditional lines. Four of these companies use a telephone follow up. Those who used the telephone follow up felt it was effective and those who did not, without having tried it, felt it was not effective. In a company that had been using the telephone program for an extensive period of time, they were phoning orphaned policyholders twenty-one days after the due date. They had some internal criticism that this really was not effective, that the policyholder probably would have paid anyway. To test this, for a three month period they called only every other policyholder on their policy list. They found a 50% better result on those that they called. Another company uses a telephone campaign on their orphaned policyholders two weeks after the grace period expires. This has been done since late 1980. In 1981 the lapses were lower than in 1980 and for 1982 to date they are about the same as 1981. Furthermore, the calling on this orphaned business produces a lapse rate that is about 20% better than the company's overall lapse rate.

On the subject of home office support for agent/policyholder communication, I have doubts as far as present traditional products are concerned and traditional agency forces are concerned. I will later express my hopes. In the research just noted on the companies I called, the policyholder retention was better when the home office telephoned the policyholder directly than when the agent was called. The traditional salesman has a particular profile and that is to sell. To expect him to service is a dilution of his talents and is ineffective. With computerization, we in the home office ought to be better able to deal directly with the policyholder on the matter of his values, always keeping the agent informed, but not expecting everything to channel through the agent. Many agents really want that control, but to expect agents to keep your business on the books does not give you the end result that you would like.

I am enthusiastic on the subject of universal life. In the first place, the profile of the salesman may well change because I think there is going to be more ability for the salesman to let the prospect consider various scenarios and let him choose from among plans of various companies that the agent has to offer. Again, he will not be purely your agent. The universal life plan is going to require that an annual report be sent from the company to the policyholder. This will open a channel of communication that many companies should have opened up in the past. The annual dividend notice or premium notice really has not told the policyholder enough about what he has with the company. The agent has told the policyholder pretty much what he wants to tell him.

The annual report is a disclosure of the performance of the policyholder's fund. A major difference from traditional policies is that this will give him a reason every year to feel good or bad about his policy. The agent needs to get a copy of that. The agent should use it to keep abreast of his client's coverage. If the policyholder has purchased the last policy he is ever going to need, then the agent is going to have to go out and sell his new insurance needs on that policy. He is also going to have to try to keep the premium flow stimulated since no premiums are required. It may be a real problem. We can send out premium reminder notices from the home office but the agent and the home office need to work together to bring more money into this policy as money is available to the policyholder. In this regard, Philadelphia Life has something in its compensation package that many of you might not have in your universal life plans. Our agents have a small percentage participation in the fund. They may not be particularly impressed by it right now. but they are going to be amazed at what this is going to mean to them as the book of business grows.

How do the new products impinge on policyholders? Setting aside the adjustable premium products, I have mentioned that we have two new products. They are annual renewable term and universal life. The ART plans with perennially reducing rates will keep up a churning that is acceptable to no one and is not profitable to the companies. It is disturbing to the policyholders and it is an empty and unsatisfying exercise to the agents.

The period of cheaper and cheaper term is coming to an end. Reinsurers will stop, or have already stopped, supporting impossibly low rates.

On the other hand, so long as universal life is kept an open contract, fully disclosed, this may be the salvation to a lot of us. The market will find that this product is the most acceptable thing. Life insurance perhaps will begin to enjoy the respect that in my 30 years in the business I have not seen to be present. I have always been amazed to find how denigrated and vilified our business is, all except one's own agent and except one's own company. The reason for this is the lack of openness in the working of the insurance contract. Universal life openly presented is a product the client can understand. The only problem with understanding universal life is to be found in the home office. We are so imbued with the actuarial mystique of our traditional insurance that we do not want to give up our special skills. I am afraid that these are the skills turning out high quality, very superior, buggy whips.

On the subject of interest groups, we are speaking of self-interest, with the exception, among the items listed in the program, of the regulators. Unfortunately, sometimes even with regulators, there is a lurking element of self-interest.

To a policyholder of a stock life company, self-interest takes the form of lower outlay for continued protection. If the policyholder is insurable, continued protection can likely be had for a lower cost. For the past few years he could have bought his annual renewable term at a lower rate with each advancing year, mortality curves notwithstanding. For our own permament life plan, the premium for $100,000 has gone continually down. The healthy policyholder should change, while the substandard policyholder should possibly change, depending upon the new rate. The company is then left with poor mortality and with a capital loss in all likelihood.

The interest of the agent, of course, is in his commissions. If he is semi-retired and has a large block of renewal business, he will not want to see his policies replaced. More likely his interest is going to be in few first year commissions. This interest may even be strong enough to bring agents out of retirement.

Management would like to see it all go away, but it will not. If the CEO of the company is the type who does best in adversity, the company may have a chance. Bradley Joern and James Miller, in their article Conservation: Wonder Treatment For The Ill Patient ("Best's Review", September 1982), discussed conservation as preservation of the value of the enterprise. Its achievement requires that policyholders are convinced that their contracts are valuable, agents have fair compensation and are given home office support for selling and servicing, and the company manages its capital strategically.

The interest of the stockholders should be the same as that of management. Ah, that is backwards! The interest of management should be the same as that of the stockholder. Apropos, the Joern-Miller article closes by quoting James Vineburgh of Connecticut General, "Any company not thinking about it is not thinking." They add in their own words: "Any company not doing something about conservation may not have to think about it much longer."

Prospective policyholders should have the same interest as the stockholder. That is to say, the company should be viable, healthy, and profitable. Also, to the extent that he has benefit of enlightment, he should buy a participating non-participating contract (that is, a universal life or an adjustable premium contract) or else he should buy a participating contract with a company that he is sure will preserve equity among old and new policyholders. I am not quite sure how he gets that assurance.

The regulators' interests should be those of the policyholders, existing and potential. When I referred to the regulators' self-interest, I was referring to a fear that sometimes in the interest of empire building, they tend to increase bureaucratic obfuscation. This only serves to increase our compliance costs without helping the consumer.

I am not going to dwell on the financial considerations. They need to be measured, but measuring alone will not solve the problem. If low interest rates persist, we may be able to weather the storm. If we are so fortunate, we make a mistake not to continue to address the problem. As I stated earlier, ART rates promising eternal life will soon be a thing of the past. At the same time, a participating non-participating product, be it universal life or an adjustable premium product, or a truly participating product with the assurance to all policyholders that they are treated fairly, will be a necessity of the future. The lines of definition between stock and mutual companies have been blurred. Even if we move into an area of stable economy, the consumer will want to know what he has and that knowledge will be the salvation of the life insurance business.

MR. DALE R. GUSTAFSON: Before I get into my presentation, I have just a couple of introductory remarks both coming from Rich Burrows' statements. He stated that he was unaware of any update program for non-par business. I am aware of one and Rich may know of this, too, but may have not included it because it is a little different. Manu-Life implemented about a year ago a unilateral update of its Canadian non-participating cash value life insurance in-force in the form of increased amount of death benefit for each policyholder. I was interested in one of Rich's concluding remarks where he referred to participating and non-participating contracts issued by stock com nies and participating contracts issued by mutual companies. Twice he emphasized that the purchaser should be concerned about equity between blocks of business when he purchased the participating product from a mutual company but there was no expression of concern on his part about equity among blocks of business under non-par contracts under which management has complete, unbridled discretion to change the price after issue with neither any legal nor any practical constraints on equity between blocks. I would love to discuss that at some length. I think we could have a whole session on it some day. We are not here for that purpose.

The focus of this meeting is conservation strategy. I am going to describe the strategy that we are engaged in at Northwestern Mutual and I will divide my remarks into four general categories so that you can tell where you are as we go along: (1) a brief introduction to our basic orientation, (2) some fairly brief comments on the fundamentals, (3) rather extended remarks on the concepts of retroactivity and what they mean to us, (4) fairly brief remarks on the current marketing atmosphere plus a brief concluding summary remark.

As to basic orientation, we are a traditional portfolio product company working through a career agent force. We do not accept brokerage business. We do not believe that this is the only possible and viable approach for any company. We are very comfortable that it is the proper orientation and approach for us but please do not misconstrue me as preaching that every single one of you should do the same thing. This is a diverse world and I think that diversity is very healthy and excellent.

We are very proud of our creative line of new products that are in the traditional mold but very competitive and successful in the marketplace.

In order to conserve our in-force business, we feel we must provide value. We provide value by being sure that we have low mortality. Low mortality comes from good underwriting, no cheating from the agents and good persistency. Low termination rates produce better mortality and lower unit costs which is the third fundamental that we list; low unit costs in both the home office and the field. The fourth key fundamental is a respectable investment return on the entire portfolio. The fundamentals of the pricing of any life insurance product comprise mortality, expense rates, voluntary termination rates (which really are an adjunct of unit costs) and investment return.

Throughout our history we have set a great store by retroactivity. In fact, one of my treasured moments is when the chief executive of another major mutual company said to me, "Gus, we neither understand nor agree with your peculiar attitude towards old policyowners." Well, we do have a peculiar attitude toward old policyowners, they come first with us and we think if we take care of that business other things will fall into place more readily. Throughout our history we have been interested in this. Again, we are not alone, but maybe we are a little more insistent about it than most other companies. When we introduce a new policy series with new benefits or when we have a new product or a new liberalization of benefit or underwriting or what have you, we always look at retroactivity. Can we extend this to all in-force policyowners on a unilateral basis? If we can, we do. I will give you some examples in a few moments. If we cannot do it unilaterally because there is a required contractual change or a price involved, then we consider doing it on a bilateral basis.

Now let me give you some examples. First unilateral. I will only give a few to exemplify the sorts of things that we have done and continue to do. The first one goes back to 1907 when we introduced the automatic premium loan (APL) provision for new business and we unilaterally extended the APL provision to all in-force cash value policies. The records available to me do not show how we informed old policyholders, but I am sure we did.

More recently when grading by size was introduced in the late 1950's for new business, we at the same time introduced a grading by size for in-force business on a unilateral basis by putting a size factor in the dividend formula. A little bit later, when we introduced differential pricing by sex for new business, we introduced a sex factor in the dividend on all in-force business.

In 1974 in connection with a new policy series, one of the more interesting new benefits that we included was the exchange of insured. Some people call this the dower provision. Daddy can dower his daughter with his life insurance policy. We find an appropriate phantom date and age at issue so that the face amount, premium and cash value remain relatively in balance and away we go. It is also a very useful and important feature for business insurance for key man insurance. You do not have to go through a termination and new issue when your vice president in charge of marketing quits and you hire a new one. You just exchange the insureds, go through a little paper work and away we go. We are still exploring what all of this means and how valuable it is. We are running into something like two hundred a month of these critters. We understand that there are a few other companies that have introduced the provision, too. We unilaterally extended the exchange of insured provision to our in-force business.

Now a few examples of bilateral changes. A small one first since it is the earliest one I can find. Some time around 1950, we discovered that we had been misinterpreting and misunderstanding one of the insurance laws and that we really did not have to cut off the waiver of premium coverage at age 60 on life paid up at 65. So we changed the coverage period to age 65 for new business and we wrote all of our in-force policyholders and said that they could have this extension in benefits, too, if they would continue to pay premiums to age 65. This was a bilateral amendment program.

In the early 1970's, along with some other companies, we offered all of our in-force policyholders a one time no-evidence-of-insurability option to convert their dividend accumulations to paid up additions. This was a response to a change in tax law that increased the advantage of paid up additions.

When we added an additional purchase benefit to disability income in 1972 and at an earlier date on life insurance, we made it available with certain very modest requirements for in-force policies as well.

When we introduced a disability income provision providing own occupation definition of disability to age 65 for new business, we also made it available for an extra premium to in-force policies in the appropriate underwriting classifications.

More recently and more importantly, when the 8% policy loan interest rate became available in enough states, we made a formal offer to our in-force cash value policies to change their policy loan interest rate from 5% or 6% to 8%. In those states where we were able to do this, that is the vast majority of our territory, we received a little over 33% acceptance of that amendment program. Why would the policyholder do this? Because he gets higher dividends, unless he is a heavy borrower. This is now available in all states.

In 1980 our first update project, UPDATE 80 we are now calling it, was offered to in-force policyholders with a reserve interest rate other than 4%. We have a large block of business that was valued at 2% and I am sure any actuary understands that this is not the most advantageous way to design a policy under the 1959 Life Insurance Company Income Tax Act, among other things. We have been wrestling for a long period of time with the question of how to solve what we used to call the 2% block problem. We wanted to do it unilaterally and could not find any way. With our comfortable success with the bilateral 8% policy loan interest rate amendment program we began to look more seriously at a bilateral program, which we did carry out in 1980 extending a little bit into 1981. We have a 67% acceptance rate of the changing of the reserve interest rate from whatever it was to 4% in return for a formula increase in the face amount of the policy. It was a fairly simple formula that increased the face amount 5% for each ½% increase in reserve rate. Then any difference between the new reserve and the old reserve was used to purchase an amount of paid up additions. The face amount increased by an average of about 15%, ranging from very small increases at the older ages to as much as 40% or 50% for some ages and durations. We have had no problems and the marketing implications have been very positive.

New offers are going to start going out soon. We are offering all in-force policyowners an opportunity to amend their dividend formula to provide for direct recognition of policy borrowing. Direct recognition applies to new business since January 1 of this year and we are now going to offer this feature to all in-force policyholders. This eliminates the subsidy between the borrower and the non-borrower, thus greatly improving equity. We are very excited about it. We made 2,500 real offers in August in two states where we had approval to measure several different approaches. Adjusting the results of that sample for the fact that we had no advertising program at that time and we did not have the field marketing package available, both of which will help the acceptance rate, produces the following interesting expectations. We realistically expect this program to change 75% of the unborrowed cash values over to a direct recognition basis and between 30% and

40% of the borrowed cash values over to a direct recognition basis, including almost 20% of maximum borrowed policies. We conducted a detailed personal interview with half of the 2,500 and they do seem to understand. We are very excited and pleased with the sample results. Our current dividend interest rates for business that has an 8% policy loan rate and a 4% reserve rate are 9% on the unborrowed cash value and 6.9% on the portion of the cash value that is borrowed at 8%, calculated on the average daily loan balance. The average daily loan balance has been a part of our basic policy record for a number of years in anticipation of this sort of effort.

One way to summarize the impact of this program is that the internal rates of return on fully UPDATED policies will compare favorably with similar internal rates of return on universal life, even using their current high interest illustrations.

We live in an uncertain world. We have had high inflation. We have had high and fluctuating interest rates. We still have relatively high interest rates, quite high on a real rate of return basis with a positive yield curve for the first protracted period in several years. How long is that going to last?

We also have recession, possibly verging on depression according to the pessimists. We have seen a change to shorter term planning horizons. We still see a very strong faith by the man on the street in the future. But the net effect of these influences is higher renewal lapse rates, higher cash surrenders and high loan activity. We think that this impact on the in-force has been exacerbated by the emphasis on replacement by some, not all, of the universal life type products. I have great difficulty in controlling my temper when talking about the cynical and unrealistic emphasis on replacing all in-force cash value life insurance by universal life and similar products.

My final summary comment is: We're okay, are you okay?

MR. YANKO: The speakers have been sharing some of their comments and views and now we would appreciate your participation, if you have any questions or comments.

MR. WALTER N. MILLER: A comment on a few things that Rich said. I can certainly appreciate his faith in universal life as the thing that is going to lead us all out of this terrible wilderness that we seem to be roaming around in. My company, New York Life, has announced that it is going to introduce a universal life product and we certainly agree that the product has a lot of potential. Rich, I did not really see what relationship your endorsement of universal life as the only product outside of term to sell in the future had to conservation. I would second what Gus said about the very unfortunate effects of some of the ways that a few companies and a few agents are selling universal life now.

With respect to Gus' impressive listing of actions that Northwestern Mutual has taken over the years, there is one school of thought that has a slightly different name for a few of the things that Gus characterized as unilateral offers. There is one school of thought that would characterize some of those as changing the rules in the middle of the game. That school would argue that a policyowner who buys a policy priced on a certain basis has an implicit contract with the insurance company that the basic pricing characteristics of that policy will continue to be that way. For example, maybe some of the male policyowners of Northwestern Mutual might have bought their policies on the basis that there was no distinction of pricing by sex. Some of those might have been a little disappointed when they learned that their company was going to a sex distinct dividend scale which, among other things, meant that their dividends were all certainly not going to be as high as they would have been had this change not been made. The same comments might have been offered by a few of the policyowners who were in the lowest size group when the company decided to start differentiating dividends by size of policy.

MR. BURROWS: Walt, I presented the universal life plan as a conservation item because I do not see that we can do an update unilaterally. However, we can allow old policyholders to switch their values to a new universal life plan. It is a product to conserve policyholders and agents.

MR. GUSTAFSON: Walt, you certainly would be aware that your comment about changing the rules after the game has started is not a new idea to us. That school would say that it is perfectly okay for Hutton Life, or any of the others, to approach our in-force policyholders and recommend replacing what they have with the new whiz bang. The key difference between the new whiz bang and our product is direct recognition. That is what enables the universal life product to show the high investment return. At least it is larger than new money vs. portfolio returns. Our response is: "We did not change the rules, we want to make the same offer to our policyholder on a much more cost effective basis." That is where we come from with regard to that argument.

MR. ROBIN B. LECKIE: Gus mentioned that my company, Manu-Life, had a unilateral enhancement of its old non-par business. This was not just in Canada but throughout the world. We did last year have a unilateral enhancement of the death benefit of our old par business in Canada whereby we provided an additional death benefit equal to the cash value less the loan value. In other words, we insured the internal savings in the policy in addition to all other benefits on those par policies and at the same time the dividends were increased.

I just want to make a couple of points. There is a need to update our old policies. There is a need to offer programs to swing over these policies into more modern policies. A lot of these old policies have out of date provisions. They have created internal inequities between borrowers and non-borrowers or between old and new policies. This is why we are doing something. Of course, we are hiding our heads in the sand if we do not do anything.

But let us recognize why we are doing something. We are doing something because we designed our policies inappropriately in the past. Partly, perhaps we were forced to. We were forced to provide loan provisions with fixed interest rates which have now come back to haunt us. The point is in making a change from the old to the new, let us not make the same mistakes. I see a lot of these conversions going right over into the new policies that are subsequently going to be replaced again in a few years. If you are going to bite the bullet on this old business through replacements, let us at least put them into irreplaceable policies.

This brings me to my last point on bilateral changes. Gus maybe was just referring to this. It is quite possible to conceive of bilateral replacement programs (generally, encouragement to replace into universal life) that can rebound on the company in a double way. First, for those who change, and, by the way, a bilateral program really does encourage a change to be made. For those who change, will they in fact get something better than what they had? How many of you who have encouraged bilateral changes into the universal life are beginning to get a little nervous now about how those policyholders are going to feel when they find out that what they got was not nearly as good as what they thought they were going to get and is not going to be as good as what they had? There is a possibility for class action. Now, what about the ones who did not accept the change? This is a class that is no longer as homogeneous as it was before. The good lives have moved off. In the bilateral program we have to give consideration as to what we have left. We probably have a group left that will not get any dividend increases but possibly dividend decreases. Certainly, they will not get any further advantages from the company. I am not too sure how Northwestern Mutual, for example, handles this on their conversion from 6% to 8%. Do those people that remained with what they had do as well as if there had been no bilateral program? There is a group with potential class action, so we can get it both ways. We have to be very, very careful on any bilateral program.

MR. LARRY R. ROBINSON: I have a question for Gus on direct recognition. One of the things that bothers me a great deal is not so much the problem that Northwestern Mutual has wrestled with for years as to the legality from the standpoint of whether the dividend differential on policy loans was, in fact, policy loan interest, although, I still think that has to be addressed, but more policyholder disclosure. I have seen some of the Northwestern Mutual illustrations that have a footnote saying this is based on no policy loan. Is there also, and are these provided to policyholders, an illustration that shows dividends which would be paid if there is a loan? The contract on the one hand indicates a loan interest rate of, I assume, 8%. Yet the policyholder, in doing what he traditionally has done, looked at his contract and made a policy loan. How is he advised as to what that really is going to cost him? We have the same question of disclosure in the universal life differential on the excess interest on loans versus the non-loaned monies. It is something that needs a great deal more attention and I would appreciate your comments, Gus, on what Northwestern Mutual is doing on that.

MR. GUSTAFSON: The offer that will be sent to each policyholder will include for each of his policies an illustration based on our current dividend scale showing him what his dividends would be like if he accepts the offer and if he does not accept the offer, keeping whatever loan he currently has outstanding at the present level. That is what the basic automatic mailed out offer form will show. We are providing a very large packet of market materials to our agents, including a copy of what is going to go to the policyholders. We are making available to the agent what we call in-force ledgers on a wide variety of different assumptions so that he can show the policyowner what the comparison is under almost any borrowing assumption.

The policyowner in the offer form is given an 800 number. If he wants an in-force ledger, it is mailed to him the next day, with a copy to the agent, of course.