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INDIVIDUAL LIFE INSURANCE

Moderator: PAUL J. OVERBERG. Panelists: LAWRENCE SILKES, WILLIAM R. BRITTON, JR., JESSE M. SCHWARTZ. Recorder: MARJORIE A. ROSENBERG

- o Changing markets, distribution systems, products, regulations and taxes to the policyowner and to the life insurance company.

- o Strategies that respond to the changes.

MR. PAUL J. OVERBERG: Our topic today is very timely. We are in the midst of change.

Within the next 40 days, the life insurance industry may have two different membership meetings of the ACLI.

- o The first is planned to take place on April 26 to discuss an industry position on a federal income tax bill. Yet, this meeting may not come to be--simply because there may not be a compromise bill to discuss.

- o The second will undoubtedly take place in early May. This meeting will be on unisex rating and, as I understand, it will be the first ACLI membership meeting that resulted from a grass roots effort to overturn an ACLI Board decision.

These two meetings, plus the announced intention of some members of Congress and the Treasury Department to consider taxing the inside buildup of cash values, adds a note of uncertainty to our discussion today.

Our first speaker is Lawrence Silkes, Vice President and Chief Actuary of New Jersey Life. Larry describes his responsibilities as anything that looks like or smells "actuarial".

MR. LAWRENCE SILKES: Trying to apply military strategy to the business world is very useful, although the analogy is somewhat incomplete. We could say that some companies have been defensive about other companies writing Universal Life. Their attitudes are Maginot Line thinking: a World War I French attitude based on the theory that defense is essential to warfare. However, the French fell to the German Blitzkrieg within five weeks; having been out-maneuvered in their defensive position. Another example is companies that rush head long with a single product which is priced uneconomically. This may be described as a Komikazi action. The military analogy is incomplete as war implies winning and losing.

Perhaps a more suitable metaphor to describe the past 10 years for small companies would be the ecological model. Here the company tries to find its niche in the market; management's job would be one of "niche" picking.

The ability of any organization to survive in its niche depends on the outside environment. For an insurance program, the constraints are the competitive action of other companies, regulatory constraint, available capital, market size, etc.

One of the major realizations is that statutory accounting is only a constraint. The real question is, do the economics of the situation make sense? Does the company earn more money than it pays out, including the cost to stay solvent on a statutory basis?

Successful products in recent years are those that have filled a need for the insured or the agent. The insurance industry has found methods to solve regulatory constraints. Or is it the other way around? After actuaries found ways to relax regulatory constraints, they came up with products that would be marketable.

What has happened in pricing has been truly a vindication of supply side economics. The competitive companies realized that if there is a way to improve the company cost, the lower cost could be passed on to the consumer. Mortality factors recognized smokers, preferred risks, and sex. Some companies even attempt to recognize further improvements in mortality, by assuming that the current trend will continue. Expenses are based upon two factors. If business grows, increased cash flow will help lower the administrative expenses on the new business. There is a point where the company can operate efficiently. Below this point, the company can accept increasing amounts of business without increasing overhead. However, if this point is reached and no other action is taken, disaster may occur because the amount of new business may become overwhelming. Term products or graded premium whole life products are using tax losses created by electing the 818(c). Reinsurance is also essential in pricing: by accelerating earnings or minimizing the surplus strain caused by the reserve. Improvements can be recognized in pricing because now the actuary does not have to guarantee all the assumptions; the risk can be shifted to the buyers.

The current term products are mortality driven, tax driven, market driven, and reinsurance driven. The select and ultimate term product is an example of a poorly designed product. The low going-in rate with increasing premium in later years, obviously encourages replacement. Companies have developed plans assuming that no one else had a similar plan. As soon as another company introduces a new product, another invitation to lapse and replacements exists.

Leveling commissions on the select and ultimate product is not a solution. The current compensation on most policies does not provide an adequate income to an agent. For $250,000 of insurance protection, the total premium is $250; a 55% commission rate provides only $137.50 to the salesman. This is not worth the agent's time to make two calls for the sale. If commissions are levelized at 25% in the first year, the agent will only receive $62.50. The product was supported with reinsurance deals and was able to create tax losses. Both these supports are being removed.

There will continue to be a market for term insurance. What will be the structure of and assumptions used in the product? (Recall that select and ultimate term are mortality and tax driven, not persistency driven.)

1. Rates that start relatively high then dip. This will reward the persistent policyholder.

2. Term policy with cash value wrapped around it. This is just the old *minimum deposit plan.*

The interest rate used in pricing will be the loan rate, with expenses adjusted to reflect additional loan activities. The cost of the rider to purchase term on the cash value can be a balancing feature.

We are then selling value to the insured. If the owner's net outlay is lower because of tax deductions, then our price does not have to be competitive compared to other term products and the plan will persist.

This product will have no problem with the 818(c) adjustment because it is whole life. The renewal commission may have to be adjusted to reflect the fact that a portion of the premium is just an exchange of dollars. The insurance industry is competing for the savings dollar when it offers products that take advantage of the tax law. Annuities have provided a source of the investment dollar to the insurance industry. However, TEFRA has placed some restraint on them. A product that appears to have less obvious restrictions is single premium whole life. Withdrawal can be accomplished through noninterest loans. The final accumulation is paid as a death benefit which passes to the beneficiary tax free. Excess interest buys paid-up additional insurance at the current rate. One serious restraint on the product is the Section 101(a) definition of life insurance. Now only case law exists to define life insurance. The IRS may want to use the TEFRA guidelines as described in Section 101(f). The joint committee stated that all that is not life insurance is an annuity policy plus a term rider.

Minimum deposit products have appeal for several reasons. The agent receives full commission on the premium whether the premium is paid or borrowed. The insured lowers his actual outlay and can further decrease his effective outlay by receiving a tax deduction.

There is no need for a minimum deposit policy to have a level death benefit or just a return of the cash value as a death benefit. It is possible that a different pattern of death benefits could create a more viable product. The object is for the product to be paid with tax deductible interest.

1. The death benefit is the return of premium with interest.

2. The cash value is equal to at least the accumulation of the premium at the loan interest rate.

The use of indexed loans could offer greater tax leverage to the buyer. There are many uses for the product so designed. For example, the large cash buildup and no accounting cost to the company make it viable for key man and split dollar situations.

As an actuary for a small company, I am integrally related to the marketing aspects. We found out, in retrospect, that certain combinations of events work. The sources of the information is interesting. The companies I worked with were "me too" companies, looking at what was successful and copying the program with a slight improvement.

Right now, I don't feel comfortable with Universal Life for the company I work for. The current environment, if the product proliferates, would provide little advantage, for either the insured or the agent. My company has a quasi-Universal Life product with a fixed premium which pays excess interest.

To summarize, no one can predict what will be successful, but either one or two of the trinity, buyer, or agent must benefit and finally, the third law of the trinity, the company and its supplier (reinsurer) must make money.

But my chairman consistently asks me these two questions:

Do we need new programs and products?
What are we doing about it?

MR. OVERBERG: Our second speaker is Mr. William Britton, Vice President and Principal of the Tillinghast firm. He is in charge of the Hartford office which he opened in 1981.

He has broad experience in reinsurance, agency operations, market research and planning, as well as appraisal of acquisition and mergers.

MR. WILLIAM R. BRITTON, JR.: My purpose is to look at some of the trends in taxation of the life insurance industry and its products, describe the current TEFRA tax environment and its potential impact on product pricing and development, and then to look ahead to what might be expected after TEFRA.

To do that, let's look back in time at some of our Firm's ideas of the industry's outlook prior to TEFRA. Jim Anderson, the President of our Firm, is fond of the metaphor, "The Four Horsemen". These four horsemen are not the Four Horsemen of the Apocalypse. Neither did they form the back field for Notre Dame. Rather, they are the major forces which are threatening the life insurance industry.

The four horsemen threatening the life insurance industry's survival are taxation, expenses, replacement, and inflation.

Taxation

The taxation of policyholder investment earnings taking place inside life insurance companies, driven relentlessly by high interest rates, increases not only the investment income subject to tax, but also increases the rate at which investment earnings are taxed. This phenomenon threatens the industry's ability to provide acceptable rates of investment return to its policyholders, which, in turn, threatens the viability of the products sold.

Expenses

We are a high expense industry and our expenses are particularly high as related to the savings element of traditional life insurance products. A company with a traditional agency force has a distribution system dilemma: the agent cannot afford the company and the company cannot afford the agent. As a result, some companies are pursuing alternatives to their existing systems through brokerage, PPGA's, and mass merchandising. At the same time, the average agent's income is declining in real terms, and agents are seeking ways to enhance commissions when the industry can least afford it.

Replacement

Replacement falls under a broader category of disintermediation. That is, the decline of the life insurance industry as a savings medium. Disintermediation occurs through lapsation, increasing policy loan utilization, the continuing shift towards term insurance as well as a wave of product replacements within the industry itself. It also occurs with a substantial opportunity cost as new savings dollars are being invested in other media.

Inflation

Inflation is the engine that drives all four horsemen. It is also significant because it depreciates the value of the product which we traditionally have sold.

Prior to TEFRA, we as a Firm were rather pessimistic on the industry's ability to deal effectively with these forces. Subsequent to TEFRA, and in view of other economic changes, we have revised our outlook from pessimism to cautious optimism.

Taxation

What happened under TEFRA? Several things:

- o We lost MODCO 820 forever.
- o We had a deceptively modest reduction in 818(c)2.
- o A lot of the teeth were taken out of reinsurance as a tax planning tool.
- o Universal Life was given legitimacy through 101(f).

In terms of Anderson's Taxation Horseman, it is now clearly possible for the industry to provide a competitive rate of interest return to policyholders--at least on new money products. The matter of the existing portfolio of assets is another question, but at least on new money products, the industry is in the position of being able to offer competitive products. In addition, the 818(c)2 adjustment is available for the first time to many companies.

Expenses

Several things have happened on the expense scene as a result of TEFRA. Most mutual life insurance companies and most mature stock companies now find themselves in the position of being taxed on gain from operations. For many, this means that expenses are tax deductible for the first time, transforming a 100 cent expense to a 54 cent expense. In terms of its impact on products, this is essentially the same as a 46% reduction in expenses.

Replacement

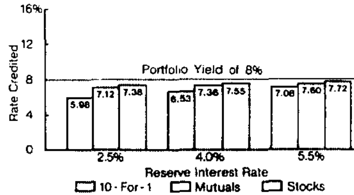
Congress helped out the industry by removing the threat to annuity writers of a possible run on the bank. That run on the bank quite possibly could have fanned out and become an indiscriminate run on the industry at large. TEFRA essentially blessed what had happened in the past, placed a safety net on the annuity business from the company's viewpoint, and essentially removed what was a very urgent and menacing threat.

Inflation

Finally, TEFRA itself did not do much about inflation but, in a sense, may have contributed quite materially to reducing inflation and inflationary expectations. However, this may be only a temporary phenomena.

Let's take a look at some specific TEFRA effects.

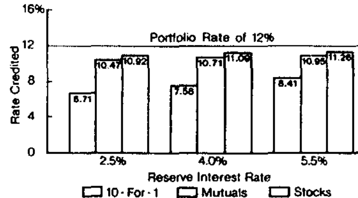
Maximum Interest Rate that can be Credited if Portfolio Yield is 8%



This chart shows the maximum interest that can be paid with a portfolio rate of 8% and reserve rates of 2.5%, 4.0%, and 5.5%. For example, at the 4% reserve rate under the 10 for 1 rule, 6.53% would be payable. Under TEFRA, mutuals can pay 7.36% and stocks 7.55%.

At higher interest rates the value of the TEFRA changes becomes more apparent.

Maximum Interest Rate that can be Credited if Portfolio Yield is 12%



At a reserve rate of 4% and portfolio rate of 12%, the maximum interest credited was 7.58% before TEFRA. This has been increased to 10.71% for mutuals and 11.09% for stocks. These are dramatic increases.

Now let's take a look at the specific impact on products. For these purposes, I will concentrate on products issued primarily by stock companies, that is, Universal Life, guaranteed cost, indeterminate premium, and graded premium whole life.

Earlier I referred to TEFRA as having resolved some of Jim Anderson's four horsemen issues. In doing so, TEFRA introduced four horsemen of its own. The writers of the above products have to deal with four major unresolved tax issues. First there is the 818(c)2 deduction, which has been reduced from $21 to $15 for permanent products. Secondly, is the question of whether excess interest will be considered a dividend. Thirdly, is the question of the availability of the nonpar deduction on nontraditional, nonparticipating products. And the fourth is the phantom premium; that is, the difference between the maximum premium and the current premium for an indeterminate premium life policy and the difference between the maximum cost of insurance versus the current cost of insurance for a Universal Life policy. The question is whether or not this difference is a dividend.

In the interest of time, we will focus on Universal Life and take a look at the impacts of its pricing. To do so, we will look at a company in Tax Situation A (i.e., phase two negative) where the company is taxed on gain from operations.

I have chosen a $100,000 face amount at ages 35 and 55 and a typical Universal Life target premium plan. I have assumed earned interest at 12%, credited interest at 10%, 100% first year commission. The product has been priced to have a 5% profit margin after tax on a pre-stopgap basis.

Universal Life

Description	Tax Sit.	Sp. Ded. %	Dividends	N P Ded.	818 (c) (2)	Profit Margin 35 %	Profit Margin 55 %
1. Pre S-Gap	A	0	none	0	none	5.0	5.3
2. XSI Div.	A	85	XSI	0	none	−0.9	−1.2
3. Phantom	A	85	Pha	0	none	−2.6	−3.5
4. Stock Worst Case	A	85	XSI+Pha	0	none	1.5	0.6
5. Non Par	A	85	0	10% V	none	+2.0	+1.5
6. $5 818c	A				5	+4.6	+1.1
Non-Par on 818 Reserves	A	85		10% V	5	+0.4	+0.1
7. $19 818c	A				19	+17.4	+4.1
Non-Par on 818 Reserves	A	85		10% V	19	+1.4	+0.4
8. Best Stock	A	85	0	10% V	19	25.8	11.3
Best Mutual	A	77½	0	10% V	19	25.5	11.1

1. For pre-stopgap purposes, the product is priced assuming no dividends, no nonpar deduction, and no 818(c) adjustment for reserves. This was the most common pre-TEFRA tax assumption used in pricing Universal Life.

2. By considering excess interest, there is a loss of .9% in margin at age 35 and a 1.2% loss at 55.

3. If the difference between the maximum cost of insurance and current cost of insurance (i.e., the phantom premium) is considered to be a dividend there is a more dramatic effect.

4. If the IRS wins on both issues, i.e., a worst case scenario, the 5% pre-stopgap margin has now been reduced to 1.5% at 35 and .6% at 55.

5. If the industry is successful in winning the nonpar deduction issue, about 2% of the lost margin will be restored at 35 and 1.5% at 55.

6. A $5 818(c) is worth about 4.6% in margin at age 35 and 1.1% at 55.

7. For a $19 adjustment, the corresponding numbers are 17.4% and 4.1%. Both of these may have a residual effect on the nonpar deduction.

8. A best case scenario looks like this.

We conclude that resolution of all of these issues will have a considerable impact on Universal Life product profitability, with the 818(c)2 deduction having the most critical financial impact.

What about all of our traditional products? For traditional guaranteed cost whole life, the combined effect of 818(c)2 reduction and Menge change gives a modest increased profit margin, which is not likely to improve guaranteed cost whole life's relative position.

For indeterminate premium products, I looked at a typical whole life policy issued to a male 35 nonsmoker. For a pre-TEFRA Situation a company claiming a $21 818(c)2 deduction, the anticipated margin would be 12.5%. Under TEFRA, with a $19 818(c)2 adjustment, and a nonpar deduction based on the reserve increase, the margin increases to 15.8%. Under a worst case TEFRA scenario, (i.e., no nonpar deduction, "phantom premium" taxed as a dividend), the margin reduces to 8.7%; a significant, but perhaps affordable change.

The value of the 818(c)2 deduction becomes clear when a graded premium whole life policy is considered. I looked at a policy which has ART-type premiums for the first twenty durations, with level premiums thereafter. I assumed that it would be priced to break even at male age 35 before tax. With a $5 818(c)2 adjustment, the margin increased to 11%; with a $21 adjustment, the margin became 49%.

What do we conclude from all this?

- o There's been a significant improvement in the interest throughput. We now have an attractive investment vehicle when the interest throughput is coupled with the inside buildup.

- o Graded premium whole life has lost its luster, particularly if the reinsurers pull in their horns.

- o There is considerable uncertainty about the taxability of nonparticipating, nontraditional products under TEFRA.

- o Mutuals and mature stocks can now write tax-efficient products, and in fact are doing so. We have recently seen some aggressively-priced participating permanent products as well as term products.

The tax related product strategies, unfortunately, are short lived as TEFRA expires at the end of the year. Perhaps the main message is to gather your rosebuds while you may, and sell as much 818(c)2 sensitive business as you can while it is still available.

MR. OVERBERG: Larry Silkes implied the select and ultimate type product is on its death bed and just waiting for an appropriate funeral. Bill Britton was a little more kind. Is there anyone who disagrees with these comments about this type of product?

MR. JAMES KNUTSON: For a small company, the statement might be true. We have found that with a captive sales force, we gain somewhat on the reversion. In other words, we do not have the twisting and churning that some of the larger companies have found. We priced it using $5 per $1,000, knowing that $19 per $1,000 was ridiculous. Actuarially we are not very comfortable. However, comfortable products do not sell any longer.

MR. BRITTON: What happens if you have no 818(c) adjustment?

MR. KNUTSON: We use an internal rate of return. We would still have about an 8% internal rate of return even without an adjustment. Right now, we do not have any investment because of the 818(c).

MR. SILKES: Is the product reinsurance driven?

MR. KNUTSON: We use reinsurers because we do not know what is going to happen. The biggest question is how many people are going to continue with the product versus how many will re-enter. If you have a captive sales force, you are not sitting out there with million dollar cases looking every year for the best buy.

MR. JOHN E. TILLER: Considering the rate at which business is being sold, especially of the graded premium products that may or may not qualify for the 818(c) and of the rapid growth of universal life, what happens to Mr. Britton's scenario, if there is not a tax in which you could offset the 818(c) being generated by other products and portfolios?

MR. BRITTON: I think that is a problem.

MR. TILLER: In Mr. Britton's scenarios for Universal Life, a large portion of the profitability results from the tax deferral benefits of Section 818(c)(2). It should be observed that this benefit is realized only if the company is generating sufficient taxable income on other products to take advantage of the Section 818(c)(2) "savings". A company with rapid growth in new business may find that the "tax benefits" are not attainable.

MR. BENARD WOLZENSKI: Without any particular knowledge about the tax package, Mr. Britton did not describe the worst case. The case shown uses an 85% special deduction, meaning 15% of what might be construed as advanced premiums, to be taxable. He said that the stock's deduction was 100%, in which case I am not sure of the significance of something being construed as a dividend or not, if you are deducting 100% anyway. The chart indicates that there certainly is a difference between an 85% and a 100% deduction.

MR. BRITTON: Right. I do not think the 100% is going to survive if this proposal stays.

MR. SILKES: Has any decision been made regarding the 818(c) deduction and the product that is known as Irreplaceable Life?

MR. BRITTON: It would seem that Irreplaceable Life would have more of a chance of getting a permanent 818(c)2 deduction than Universal Life would, because it is a permanent product (at least some of the later versions). I am not sure whether Irreplaceable Life would get a nonpar deduction. It is also unclear whether the excess interest that is credited on the accumulation accounts would be taxed as dividends. The major advantage it offers life companies is a better shot at getting the 818(c)2. The major advantage from the policyholder standpoint is developing a minimum deposit type vehicle. This is difficult to do on Universal Life since it does not have fixed and due premiums.

MR. OVERBERG: Our third panelist is Jesse Schwartz. Jesse is Vice President - Individual Insurance Actuary of the Mutual Life of New York. He is responsible for the development of individual life insurance, annuity and disability income products. Jesse has become known as an expert in the product development area and has some definite ideas on where we, as an industry, are headed in the balance of the 1980's.

MR. JESSE M. SCHWARTZ: My remarks are based on 16 years of observing the life insurance scene from the perspective of an actuary employed by a mutual life insurance company operating under a branch manager agency system.

I consider myself a practical idealist. Idealism is necessary in developing strategies, since only idealists will dare to challenge methods of operation based on tradition. Practicality is important to determine whether those strategies should be evolutionary or revolutionary.

The simplest definition of strategy may be found in McMillan's Dictionary for Children. Strategy is defined as a plan for achieving a goal. Individuals, particularly actuaries, entrusted with development of individual life insurance strategies, should consider the following:

1. If a strategy appears to have strong sales appeal, but depends upon unreasonable expectations for its financial success, it is doomed to failure and should not be implemented. Briefly stated, if something looks wrong, it is wrong.

2. A maniac is a strategist, who upon losing sight of a goal, redoubles his efforts.

3. Never sacrifice long term gains for short term successes.

As a firm believer that we learn from our past mistakes, three strategies will be discussed which were intended to respond to three specific environments. These strategies have either failed or are doomed to failure.

Strategy I

The time period is the latter half of the 1970's. The inflation rate is high. Permanent life insurance is under attack, among other reasons, because its value dwindles in this environment. The real income of the average agent is decreasing. First, the average premium per thousand is going down as a result of companies introducing products based on the 4% valuation interest rate basis. Secondly, the trend toward term insurance is commencing, creating further pressure on average premiums. Thirdly, inflation is reducing the value of renewal compensation. As a result of these forces, it was difficult for our case study company to meet premium growth goals. The advent of lower premium plans did not necessarily produce higher face amounts to more than offset premium reductions.

One company with a history of high premium permanent plans of insurance designed to optimize performance on a 20-year net cost basis, decided to respond to this environment by developing a whole life plan whose face amount increased based on increases in the Consumer Price Index. Each increase in face amount generated an increased premium based on attained age, but each increase in premium was not accompanied by an increased policy fee. Hence additional coverage was provided on a more cost-effective basis than the purchase of additional policies. From the field underwriter and premium growth viewpoints, the design of the plan provided that the increases were almost automatic so that the field underwriter earned additional first year commissions with little effort and the company achieved its growth goals.

The strategy which appeared sound and destined for success, failed. Two years prior to the introduction of its CPI plan, which had been in development for five years, a lower premium plan was introduced which captured over a third of new sales as measured by volume. One year prior to introduction of its CPI plan, the company had a choice to make: continue on its current path and introduce a high premium CPI indexed plan, or delay introduction by one year and develop a low premium version. The company opted to proceed for two reasons. First, they wanted the quick success which they believed the CPI plan would provide. They believed the introduction of the concept would surge new sales contrary to the trend to lower premiums. Secondly, they wanted the concept attached to a high premium plan to bolster agents' income.

Their CPI plan resulted in less than five percent of new sales by volume, although at least 80% of those buying the policy accepted the CPI related increase. Consider the impact on the company's and agents' income, if the policy had represented twenty percent or more of new sales. Why did the company fail?

It lost sight of the changing environment...the trend to lower premium plans ...and anticipated a quick success which turned into a long term failure. The company chose to change its environment rather than respond to it. It was overly concerned with the short term impact of continued lower premium plans on premium growth and agents' income rather than the long term potential of semi-automatic increases on premium growth and agents' income.

Strategy II

With respect to select and ultimate term, companies have, for the first time, designed a plan whose profitability relies upon an uninformed consumer not to pursue a course of action in his own best interest. That course of action is for healthy lives to replace their policies as soon as possible. To further complicate the profitability problems, first year commissions are often payable at a rate in excess of 60% even though the policy is of dubious persistency. Companies recognize the likely persistency problems and steepen their select premium scales in an attempt to recoup their acquisition expenses at an earlier duration. This is only likely to aggravate their anti-selection/persistency problems, as it increases the incentive for healthy lives to replace their policies soon after issue.

Given all the problems which have been identified today, as being related to select and ultimate term, why do we have it today? Because one company introduced it and successfully marketed it. The plan became popular because of an environment which had a short term orientation and demanded lower cost. Attained age YRT premium rates could not be reduced sufficiently at the higher issue ages to compete with the very aggressive companies. Other companies followed to avoid losing their distribution systems to the companies willing to risk the losses associated with these plans.

Strategy III: The Universal Life Strategy

Let's examine the environment to which universal life responds and the potential causes of failure by a company implementing this strategy. If we strip away the investment environment in which this plan was developed, two principles underlie its design.

1. In a society without predictable patterns, life insurance products must provide, on a cost-effective basis, for variations in the ability of the policyowner to pay premiums and the need for insurance. The phrase "cost-effective" is most important since the competitive environment is likely to intensify as the consumerist movement evolves.

2. Life insurance companies theoretically compete only among themselves for the acceptance of risk; although this is likely to change. Therefore, the cost to acquire the risk portion of the premium dollar is only governed by competition within the industry. However, many financial institutions compete for the savings portion. The life insurance acquisition costs for this portion of the premium dollar must be competitive with these institutions. We cannot assume that the inside cash value buildup will forever be sheltered or if the tax-sheltered aspect continues, it will be sufficient for the policyowner to tolerate greater acquisition costs.

In my opinion, there are two potential problems in the implementation by some companies of the universal life strategy. First, consider the trend toward higher commissions on universal life type policies, hence higher loadings, because of the fear that the product will not be marketed by agents. Instead of companies expending any effort towards improving the productivity of their agents in an environment which exerts downward pressure on commission scales, they assume that the agent, rather than the policyowner is their client. Are there any other industries which intentionally increase prices to absorb higher distribution costs in an environment which demands lower cost, and prosper in the long run?

Secondly, traditional life insurance cash values are typically a reserve less a surrender charge. In the mid 1970's, deferred annuities began the evolutionary process from the front-end loaded to the back-end loaded contracts available today. History appears to indicate that a product with a savings element ought to provide better performing products to the persisting policyowner. The majority of universal life contracts are essentially front-end loaded, either directly, or indirectly in the form of high-cost insurance rates. While companies may have been restrained from the introduction of back-end loaded contracts because of system's consideration, it will be interesting to observe if the switch to the back-end load will be evolutionary or revolutionary.

My remarks centered on strategies which have failed or appear destined to fail because they either were not designed on a financially sound basis, or did not respond to the needs of the marketplace. In some instances, the failure arose from an unreasonable preoccupation with the preservation of the distribution system, as it is currently structured, instead of assisting it to evolve to a more productive system. For those of us who believe in life insurance marketed by professional field underwriters, our task is not to preserve the current approach to field compensation, but rather to create an environment in which the field underwriter may prosper. The goal is to market financially sound products on compensation arrangements necessary to optimize competitive performance.

My prognosis for the future:

1. The career agency distribution system will survive. Professionally trained field underwriters must be developed to market a complex product intended to respond to a complex environment. In

addition, a corps of career agents will provide a company with a basis for growth, assuming products are competitive and substantial market support is provided.

2. Companies will recognize that they cannot provide all the products their career agents want to market. Recognizing the value of their distribution system, companies will use the system to market the products of other companies which they do not offer and be paid for the effort. The results from the sale of other companies products will be monitored to determine if the company should enter that market.

3. Career agency companies will develop subsidiaries primarily for the purpose of experimentation in field compensation systems, as contrasted to tax-savings, since the successor to TEFRA attempts to equalize taxes between all life insurance companies. As this process must be evolutionary, the parent company will continue to market through existing field compensation systems. Great care must be taken to avoid the creation of a block of business which is ripe for replacement by the more competitive products of its subsidiaries.

4. Branch manager systems (which currently compensate managers primarily based on acquisition of business with little or no financial incentive related to the profitability of business, persistency and unit costs) will slowly evolve into general agency systems with greater emphasis on profit, persistency and unit costs. Products marketed by these companies will be gradually introduced into their subsidiaries where branch managers will be contracted as general agents.

5. Field underwriter commission scales will be levelized with fees for service for complex life insurance planning.

6. Ultimately, the only products marketed will be...

   - Universal Life II or Separate Account Universal Life
   - Variable Annuities
   - Yearly Renewable Term provided for a limited period of coverage (e.g., 10 years) on an attained age premium basis.

   The first two plans will be the acknowledgement by the industry that the investment risk associated with guaranteed cash values in a volatile investment environment is not acceptable. The variable loan interest rate will not be a solution to the problem. In some instances, it may aggravate the problem. Zero cash value plans may eventually be added to the list. Yearly Renewable Term (YRT) will only be provided for a temporary period of coverage on a convertible basis. Longer periods of coverage will not be necessary as permanent life insurance plans will be designed to optimize performance as measured by its yield. YRT will only be used for those consumers with a short term need or the inability to commit to the higher premiums for permanent plans of insurance.

My observations on the successes of past and current strategies may be considered by some to have been lengthier than the prognosis for the future. However, the uncertainty of the regulatory environment on such issues as taxes and unisex rates, and the restrictions of current laws and regulations (e.g., nonforfeiture/valuation and SEC requirements regarding separate account Universal Life), make it difficult to experiment on product strategies which appear appropriate for the future.

Field compensation experimentation will proceed slowly; therefore, there will be little tangible progress for some time. Finally, on the subject of improved field productivity, computers (i.e., the new technology) will play a significant role.

MR. OVERBERG: Jesse made six predictions in his presentation. Do we agree that the career agency system will survive? Jesse did not predict what would happen to other distributional systems. He addressed the one distribution system which has been attacked by other speakers at other meetings. I imagine if the Mutual of New York continues their career agency system and is successful, other companies' systems will also survive.

The second point was that life insurance companies cannot be all things to all people. They have to specialize in some kind of brokerage arrangement and have their agents work through their brokerage system. Will the companies without a captive field force have the courage, as Jesse suggested, to fire agents who broker direct rather than through the company brokerage firm? Can they afford to fire their agents if and when they catch them selling direct, after they have spent the time training them?

MR. SCHWARTZ: They would not do it the first time. They do not have that much courage.

MR. SILKES: Doesn't every career agent contract have a clause that if they sell for another company they can be fired on the spot?

MR. SCHWARTZ: Yes, but it is not enforced.

MR. SILKES: But it is there. What you are saying then, is that there should be a change in attitude?

MR. SCHWARTZ: Yes.

MR. WILFRED A. KRAEGEL: Jesse, you suggested that the only products viable in the future will be Universal Life, Flexible Premium Annuity, and Yearly Renewable Term. Could you elaborate on your statement that we cannot be all things to all people and that our product line will be potentially small in the future?

MR. SCHWARTZ: Companies will still grow and prosper. Products that I have described are the ones that will be sold by those companies. There will probably still be companies in 1990 selling Ultimate Term for some reason. There will be companies in 1990 selling Baby Group and also underwriting for people that are on their death beds. The premium rates given may be better than those we would. Given that _if_ you have career agents and _if_ they want to sell that business and _if_ the company is setting up the

brokerage arrangement, then you still have to make the products available to your agents.

MR. THOMAS F. EASON: I work in a substantial mutual company that started writing Universal Life last week. There will be a panel presentation headed by Paul Barnhart that will discuss the question of client/company relationships. We are involved in a number of these, with several thousands of agents of other companies writing one of our products. We have a good sense in this situation. We have product lines that have been developed professionally and administered smoothly. Other companies involved did not feel that they wished to take the extra effort for development. In short, they did not choose to "be all things to all people". Based on discussions with a number of professional reinsurers and others, I am convinced that we will see a good deal more of that. Particularly, given the limited number of actuaries and product development capabilities infringements.

MR. BRITTON: Opportunities exist for a company to support its career agency force and to distribute other products to provide additional revenues that it cannot afford to do itself. It may decide that under current competitive conditions, it cannot manufacture a product on a reasonable basis. It may decide that there are too many tax uncertainties. I think that a number of large companies with captive forces are considering this as an outside source of revenue.

On the flip side, there are opportunities for companies to be product manufacturers and to distribute their products through other companies. This could be a symbiotic relationship that could benefit everyone.

MR. SILKES: Bill, you just formalized what has existed for the small companies since 1963.

MR. BRITTON: The arrangements are becoming formal now.

MR. SILKES: One large mutual company tried to set up a relationship with a relatively small company for selling its Annual Renewable Term. The existing field force of the small company revolted because they felt that the agents of the small company were brokerage to the small company's general agencies. Right now, part of the existence of the small company is providing the service that the large companies do not want to handle.

MR. SCHWARTZ: We just entered into this kind of arrangement with a general agent who would do the work and we would get paid for renting our distribution system. These small companies are selling products that we think are sound, but we really cannot see the product's market. The statistics on the amount our agents are brokering could wind up being one of the best forms of market research that we could possibly have. Small assurance companies could move swiftly and become the market researchers for the large plotters. Joint and Survivor and Joint and Last Survivor comes to mind as the product that our agents have wanted. We will see what happens through this arrangement.

MR. HAROLD N. DERSHOWITZ: I know that you learn from your past mistakes so I would like to amplify on the origins of Select and Ultimate plan. We introduced a plan of this sort in 1977. A large part of the motivation was

related to deficiency reserves. We could not afford the deficiency reserves on the premiums that we wanted to charge. There was a Select period and the premiums for the Ultimate period are the 1958 CSO. Re-entry was allowed five years later. If the industry worked more avidly to remove some of the onerous effects of the deficiency reserves, Select and Ultimate type products would either not be here or certainly would not have had the same impact. The industry has to begin to react more quickly; not necessarily in just the product area, but in the legislation area with regard to state regulations.

MR. SILKES: Did you get good reinsurance deals?

MR. DERSHOWITZ: As a matter of fact, when we originally made the arrangements for that product, the only other company that I know of, that had a product at that time was Convenant Life. One of the major reinsurers in the country got burned on some of the lapse rates they had experienced for that product. We had to convince them that our rates were not as steep and that we did not feel that we would have quite the same problem. Of course, the rates became steeper and steeper as other competitors tried to improve on what we had done.

MR. OVERBERG: Experimentation has occurred in some companies where a discounted product is offered which includes discounting for lower or levelized agents' comp. Does this also involve customers' ignorance?

MR. SCHWARTZ: At a field meeting, a field underwriter, who does about $250,000 a year in first year commission, got up and was trying to show other field underwriters how he sells a Life Paid Up At 65 plan with a high premium. It was really a skill. He drives up to his client in a Rolls Royce and goes in to visit with his client. Taking the client to the window, he says, "I consider myself a financial planner and my job is to help you make enough money so that some day you will own that Rolls Royce. For me to give all that help, you have to pay for my service. Your payment for that service (and I am not giving you a bad product) is to buy my Life Paid Up At 65." In any environment there are different reasons why people buy more expensive products. I would not call it consumer ignorance; but negotiated commissions.

MR. OVERBERG: Jesse's fourth prediction states that the branch manager system will gradually disappear and only general agents will be left.

MR. KNUTSON: We do not really have a branch manager system; our GA's or branch managers are highly compensated based on sales. Jesse's point was that we would have to compensate them more on persistency. I think that we are going in that direction. We will soon lower our first year commissions--both to the sales people and to the managers and put those in terms of higher commissions later. Hopefully, our philosophy will be to emphasize the persistency portion. We need to have that business on the books longer than one or two years.

MR. OVERBERG: Jesse included in his comments an indication that the industry would trend towards levelized commissions and perhaps a fee for the extra service performed in the first year. Didn't we see that there was an opportunity for the industry to move towards an extra fee with the

Universal Life product? Didn't we lose our chance with the trend towards high first year commissions on the Universal Life?

MR. KNUTSON: Universal Life commissions are still all over the ballpark. The industry has not settled down. We are getting pressure from the sales force, though, as to how they can make a living with this product.

MR. ROBERT L. SENKLER: I think that in the 1980's, we are going to see more of negotiating commissions. We are even seeing it today with single premium riders and paid-up additions with no compensation. The agents can negotiate commission today and they have been able to negotiate commissions for years. We are just becoming aware of it.

MR. OVERBERG: Perhaps those of us with captive agency forces do not see quite as much of that action as you folks do.

MR. KRAEGEL: Jesse states that the branch manager system is gravitating towards the GA system and that the commission schedules will be levelized into fees for service. It seems to me that the levelizing and fees for service will tend to gravitate more to the branch manager system.

MR. SCHWARTZ: We will see the general agent approach of more levelized overrides and more stress on persistency. The fees for service will come from the field underwriters directly negotiating with the client; like my friend with the Rolls Royce. For example, companies will develop a commission scale instead of 55% and 5%, something in the realm of 25% and maybe level tens. The field underwriter, based on his capability for overall service, will negotiate extra fees from the client. The company will not get involved at all. In setting compensation, it will be more a client/field underwriter relationship, as opposed to a company/field underwriter relationship.

Somebody has to train the agents. Somebody has to train the agent to sell to those people who need a qualified life insurance counselor. These customers are not going to buy a policy through direct mail. The field underwriter is really a self-employed individual. I know very few people, who, unless they have a good base of finances to start with, do not have to take out loans when they go into business for themselves. In training new field underwriters, you will wind up with a system of smaller subsidies than you see today. Any additional subsidy provided will be in the form of loans. The loans will be made only to people whom the GA or the company feels there is a future. The day of the enormous first-year subsidy of 150% or 250% of the commission that is generated by the new field underwriter is over. You just can't afford it in this competitive environment. Some companies have a loan transaction now. One of our top managers had a system. When he hired a new field underwriter, that new agent had to take out a $2,000 loan and turn it over to the branch manager. If he needed money, he could ask the branch manager for help. That branch manager was our number one manager and was most successful in recruiting and training new field underwriters.

MR. OVERBERG: There is an inference that in 1990 we will have only three products in our portfolio. Would you care to comment on Universal Life?

MR. EASON: Universal Life is a ratebook and more, all by itself. If you say you have Universal Life, you in fact have more of a product than you probably have in your current portfolio at the present time.

The National Underwriter has recently published their 1983 adjusted index book. There are 100 universal life policies in the back with the same type of display they have had in the past two or three years. It is really educational to look at that and see the different patterns of cash values and other aspects of the policies. If you look at the Union Central policy, you will find that the loadings are relatively steep compared to the average. That reflects relatively steep field compensation. This type of pricing fits the criteria of an actuarially sound product. Until we find that the product is not marketable, which so far does not appear to be the case, we will keep that philosophy in pricing.

A front-end load which shows up in the first year cash value is the most honest approach for our customers. This leads us to the question of the back-end loading. Jesse, your remarks on Universal Life implied to me that you believe that back-end loading in Universal Life will assume increasing importance. Did you mean to imply this? What are the actuarial strengths and weaknesses which you see in this kind of a product?

MR. SCHWARTZ: Our product is a back-end loaded contract, but we have structured it to amortize the charge over time. With a contract that relies on premium flexibility, this is ridiculous. Over time, you still have to continue to amortize that charge, even if the premium payments stop. As a matter of fact, I had a visitor from South Africa who wanted to know all about our Universal Life plan. We discussed it and he said, "Oh that is interesting. That is completely different from anything I have heard before". If you are going to have a back-end loaded contract with Universal Life, you cannot amortize it over time because you are going to lose money. Now, we do not know how successful we are going to be in our contract. We have been selling it since January 1. If an individual pays a big lump sum in the first year within the guideline limitations, he gets rid of the surrender charge. If he spreads the premium over time, then the surrender charge will run even longer. The key with the surrender charge is that you should charge those people who leave early, and not those on whom you are making money.

As long as the front-end load is matched up to loads which are expenses, it is obviously a financially sound product. There is no problem from the point of view of financial soundness. I just have trouble with the concept of penalizing the persistent policyowner.

MR. SILKES: You can see the difference in the back-end load with single premium deferred annuities. Back-end loads are more favorable to a persistent policyholder than front-end loads. For the latter, we take the money right away from the insured and never accumulate interest on it.

MR. BRITTON: Back-end loaded universal life products are no different than a back-loaded single premium annuity or no different than a certificate of deposit where there is a substantial withdrawal penalty.

In the testing I have done, back-loaded products can be as equally profitable as front-loaded products. Over a long period of time, the back-loaded one will probably have a better illustration.

MR. EASON: I would be rather careful in the analogy to annuity products. We went through a cycle where annuity products grew towards back-end loading and at the same time grew towards level commissions or commissions which are now down to single-digits first year. It strikes me that from a customer's perspective, there is a great deal of difference between an annuity product with a back-end load and a Universal Life with a back-end load. I am not saying that there are no back-end load products that cannot be conceived or properly presented in the marketplace, but I do think that analogy could lead you to some very incorrect conclusions. The principal one that I would address is the question of "honesty". There are advertisements for back-end loaded Universal Life products which say things such as, "A product in which there is no expense charge to the persisting policyholder". That language is artfully worded to convince the person who buys that there is no expense charge. That is obviously not the case in actuarial pricing. There are expenses and they will be amortized one way or another. If Jesse is true to his remarks, the amortization would be in favor of the persisting policyholder. But to imply, as some of the advertisements do, that somehow you are getting a better deal in a back-end loaded product is really on the border of misrepresentation. I realize that is strong language, but I would suggest that for anyone who looks to back-ended products that they look carefully to the disclosure. Not only the disclosure that you suggest your agent provide but the disclosure the agents actually do provide. Look into some of the history of deposit term insurance--the lapse experience, the complaints made to the companies who sold deposit term insurance without a clear understanding on the part of the customer that the deposit was often forfeited entirely or in large part. I would hate to see Universal Life, a product which I have a great deal of appreciation for, tainted by an approach in the marketplace which does not disclose the true nature of the actuarial pricing.

MR. SCHWARTZ: It is very rare that the New York Insurance Department, on an issue as important as this, gives me solace. But it did me solace with Universal Life as they allow back-end loads now. Since they have been very careful in their guidelines for advertising, they could satisfy themselves that back-end loads are acceptable.

MR. EASON: Would you comment on your reaction to the New York circular letter?

MR. SCHWARTZ: We did our best in trying to explain to the department why Universal Life (from the point of view of Regulation 49, and expense reimbursement allowances) should be treated like any other policy. The department is really concerned that this will be sold and marketed as a replacement vehicle with nonrecurring premium payments. If you understand that is their reasoning, then you can understand why they have the limitations they do for expense reimbursement and the amount of the premium for which you can obtain a whole life type allowance.

MR. OVERBERG: For those of your who are not familiar with that bit of New York dialogue, New York did not approve a Universal Life product until April 15. Their Regulation 49 is extra-territorial and it does affect any company that is licensed to do business in New York.