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INDIVIDUAL LIFE INSURANCE RETENTION AND REPLACEMENT STRATEGIES

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1. What alternative retention/replacement strategies are available? What are the issues involved in selecting such a strategy?

2. What is the impact of universal life as an internal replacement/exchange vehicle?

3. What impact do policy loan and/or benefit increase update programs have on the retention of traditional life policies?

4. How are reinsurers reacting to the retention/replacement problem?

MR. JAMES J. MURPHY: Our focus today is on keeping inforce policies up-to-date, either through update amendment programs or exchange programs. This approach to retention and anti-replacement is relatively new, with the Northwestern Mutual probably being the first to undertake such a program. That program, implemented in 1980, involved an increase in policy benefits related to an increase in the policy reserve interest rate.

Updates are extremely important in the retention of existing business. We at the Northwestern Mutual are particularly strong believers in this statement, given some recent evidence from a termination study that we did. For some past blocks of business we compared termination rates between policies that had accepted our 1980 update program and those that had not. We found, for example, in a block of business issued in the late 1960's and early 70's, that the overall termination rate was about 5% for those that had rejected our program, while for those that had accepted the program the termination rate was 2.2%--less than half of the rate for those that had not accepted. This is significant evidence of the benefits that these kinds of programs have.

MR. CHARLES C. MC LEOD: My remarks will cover the following:

1. The types of strategies companies have adopted.

2. Some information on the types of companies implementing enhancement and update programs.

3. What makes a program successful?

4. How should you decide what to do?

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Types of Strategies

Before describing the strategies actually adopted, I should state that I consider that a major goal of any existing business strategy is to maximize the value of the company, where value is defined as:

Capital and surplus.

Plus Value of existing business.

Plus Future business capacity.

Note that this goal is not necessarily the same as that of keeping existing business on the books. In some cases it may be advisable to deliberately convert or exchange existing policies for new policies.

The strategies adopted by companies generally fall into one of the following categories:

1. Do nothing.

2. Change administrative procedures.

3. Unilateral enhancement (e.g., increase the face amount of insurance).

4. Bilateral update (e.g., change policy loan interest rates).

5. Exchange, i.e., replace existing policies with new policies.

I am going to talk briefly about all five, with particular emphasis on the last three. As I describe them, think about the effect of each strategy on the value of the company.

Do Nothing

This is simple, administratively cheap and has the silent endorsement of many companies. The disadvantage is that it may be the wrong thing to do.

It may be appropriate for some blocks of policies where termination rates are low and expected to remain low. However, it is unlikely to be the best strategy for all your business.

I would like to think that the many companies who have adopted this strategy have done so following a proper review of all options. If you find, following a projection of future financial results, that the value of your company is likely to be maximized by doing nothing, then do not do anything! But do the financial analysis first!

Change Administrative Procedures

Although this strategy is unlikely to be enough in itself, it may be a very effective supporting strategy. To assess its usefulness, each company should answer questions such as these:

- How does the company rate its level of policy service?

- How easy is it for a policyholder to surrender a policy? To what extent does someone attempt to find the reasons for the potential surrender and to discuss alternative actions with the policyholder?

- How are orphan policyholders serviced? Are they reassigned to an agent who will service them? Are they serviced by a central office? Are they ignored?

- Is information available by policyholder or just by policy?

Unilateral Enhancements

These programs provide for an automatic increase in the amount of insurance. They have been relatively more common in Canada than in the U.S.A.

In the U.S.A., the increase in the amount of insurance normally results from a change in the statutory valuation interest rate--sometimes for tax reasons. The "typical" U.S. unilateral enhancement program has the following features:

- The amount of insurance is increased between 10% and 40% (the increase depends upon the age of the policyholder and the duration of the policy).

- The premium is unchanged.

- Guaranteed cash values are the same (although sometimes they are higher).

- Dividends may be lower, since the increase in the valuation interest rate results in a decrease in excess interest earnings.

In a unilateral enhancement program, the benefits after the enhancement must be demonstrably better than those before.

A variation is the "negative affirmation" approach under which the policyholder is offered the program and is assumed to have accepted it unless he specifically declines it (this is not permitted in some states).

A special version of unilateral enhancements is the one developed by Franklin Life in 1980 and described at the 1982 Society of Actuaries meeting in Colorado Springs. As part of a change in their dividend calculation method, Franklin Life introduced direct recognition of policy loan activity for each individual policy. This applies only to cash value increases after the effective date. It is not a retroactive change.

Apart from Franklin Life, companies such as Penn Mutual, Phoenix Mutual and Provident Mutual have introduced unilateral enhancement programs in the U.S.A.

In Canada, unilateral enhancement programs have been adopted by companies such as Canada Life, Confederation Life, Imperial Life, London Life and Manulife.

Unilateral enhancement programs developed by Canadian companies fall into one of the following categories:

1. An increase in the face amount of insurance (the increase may depend upon the degree of policy loan utilization).

2. A change in the basis for calculating paid-up additions.

3. The use of termination dividends.

4. The use of new dividend options.

5. Combinations of the above.

Some of these approaches may be unfamiliar to U.S. actuaries, and I will comment briefly on two of them.

The first is to base the amount of the increase in insurance on the amount of policy loan. For example, one company increased the face amount by 40% of the difference between the cash value and the policy loan. This avoids the problem of paying a policy dividend for which the dividend interest rate is greater than the policy loan rate. A disadvantage is that the program may be hard for the policyholder to understand if not explained clearly. It may also alert the policyholder to the availability of a cheap policy loan.

The second approach is the use of termination dividends. This type of dividend was first introduced in the United Kingdom in the late 1960's. British companies had earned substantial investment profits from equities and real estate. Although they wished to return some of these gains to their policyholders, they did not want to increase their regular dividend scales significantly in case they could not maintain the higher rate of dividends. The termination dividend was therefore introduced. Companies explained to policyholders how it arose, declared it for one year only, and made it clear that it could fluctuate considerably (or even disappear) from one year to the next.

The reasons for the introduction of this type of dividend in Canada are different. It is presumably intended to improve conservation, since it increases with duration and is only available for longer duration policies. One company does pay the termination dividend on surrender. But as far as I know, this is the only special dividend program that provides additional benefits on surrender.

If a company, be it American or Canadian, is considering a unilateral enhancement, points to keep in mind are:

- Keep it as simple as possible.

- Will the cost of additional insurance be offset by:

  Improved persistency?

  Reduced taxes?

Reduced dividends (or a withholding of future dividend increases)?

Intangibles such as better public relations?

What will be the likely attitude of agents?

Agents may feel that the increase in face amount will make it harder to sell additional insurance. In practice, the increase in insurance will probably still be less than needed, and the insured will have a much more positive attitude toward the company.

Bilateral Updates

Unlike unilateral enhancements, bilateral update programs require the policyholder to agree to a change in the terms of the policy. In return, the policyholder receives a change (generally an improvement) in the pattern of future benefits. Most of the initial update programs (starting with Northwestern Mutual in 1980) resulted from a change in the statutory valuation interest rate, which in turn was influenced partly by possible tax savings.

The second set of update programs, again with Northwestern Mutual the leader, has dividends that reflect policy loan utilization for those policies with a low (generally 5% to 6%) policy loan rate. Policyholders are invited to amend their policies so that:

(a) A variable policy loan rate may be charged (e.g., Massachusetts Mutual).

or

(b) The dividend formula directly reflects an individual's degree of policy loan utilization (e.g., Northwestern Mutual).

There is generally no change in the amount of insurance, the premium or the guaranteed cash values. Dividends are always increased in situation (a); dividends after updating are nearly always increased for nonborrowers in situation (b).

A disadvantage of "policy loan" updates is that it is not always clear whether or not it is in a policyholder's interest to amend his policy. If he doesn't borrow, he should certainly accept the offer. If he has heavily borrowed, is in a high tax bracket and doesn't expect the tax act to change, he should also accept the offer. For others, the choice may not be so clear. Extensive (and expensive) computer support proposals may be necessary, and an agent will need to review each situation with his client--for which he will probably expect to receive some compensation.

In some companies, nonborrowers may be subsidizing the borrowers (this may be a primary reason for considering this type of program). However, if only nonborrowers decide to amend their policies, can the existing dividend scale continue to be paid to the borrowers who remain? If it is reduced, will conservation deteriorate further?

Despite these disadvantages, an update program should be seriously considered and the costs and benefits carefully quantified. The additional costs (not just the benefit costs, but also administrative and compensation costs, as well as additional dividends to nonborrowers) may be high, but the improved earnings resulting from better conservation and reduced policy loan utilization can also be significant.

Exchange Programs

As their name implies, these programs allow policyholders to exchange existing policies for a new product. The terms of the exchange are sometimes more favorable than those applicable to the issue of a new policy (for example, limited underwriting requirements may apply and/or the cash value of the old policy may be transferred with less than the normal loadings for a new policy being applied to it). Commissions on the exchange are generally less than those on a brand new sale.

Such programs are not new. Companies have had policy change and replacement rules for many years. What has happened in the last several years, however, is that new policies (e.g., universal life and nonsmokers) have been introduced which require revision of these rules.

In almost all cases these changes have not been publicized to the policyholders. Thus, companies have not encouraged their policyholders to exchange existing policies for a new product. When changes are made to policy change and replacement rules, only a company's agents and staff are normally informed.

As with the other strategies I have described, a financial analysis is necessary. Older permanent policies may be very profitable--probably more profitable than current policies. It may be possible, however, to offset some of the decrease in profits brought about by an exchange by increasing the amount of insurance on the new policy. Profits on the replacement policies will also be influenced by any compensation that is paid on the transaction.

Key points to keep in mind are:

- The program will need to be carefully explained to each policyholder.
- It may not be in the interests of the policyholder to elect the offer (because of income tax implications or the loss of a low cost policy loan).
- If compensation is inadequate, the agent may simply consolidate a client's policies and sell him another company's product.

Who is Implementing Enhancement Programs?

In June of this year I did some research into how many U.S. companies had actually implemented unilateral enhancements or bilateral update programs (not exchanges). I could find less than 20 companies who had implemented, or were about to implement, such programs. I may have missed a few companies, but I would be surprised if the true number is over 25.

About two-thirds of the programs were unilateral enhancements; one-third were bilateral updates.

Only two of the companies are stock companies. These two exceptions are both owned almost totally by single entities and sell both participating and nonparticipating business. The mutual companies sell only participating business.

Almost all of the companies are large. Only two had assets of less than $500 million. This may reflect:

- The administrative cost of implementing an enhancement or update program.

- The fact that a small company is less likely than a large company to have a relatively large block of inforce business.

I did another survey in Canada, at the end of 1982, to find out what had been done for existing policyholders there. Twenty-five companies responded, including almost all the large ones. Some of the results are quite interesting.

In the term insurance area -

When introducing new, lower term rates, six companies out of 25 had automatically improved benefits or advised policyholders directly that benefits could be improved by completing a smoking questionnaire and/or a short form questionnaire.

If an agent replaced a client's policies internally:

- First-year commissions were normally paid only on the increase in premium (or amount of insurance).

- The change was generally not treated as a lapse.

For deferred annuities -

What did companies do for existing policyholders when they introduced new (improved) plans? Only <u>one</u> made an automatic improvement, and this was not normal practice. Only <u>two</u> companies advised policyholders that new plans were available.

And in the permanent insurance area -

Nine of the 25 companies had made changes which resulted in an increase in benefits. The types of programs were described earlier. The nine companies are fairly large companies with significant volumes of inforce insurance.

What Makes a Program Successful?

The following factors are generally necessary for success (conversely, the absence of them could make a program unsuccessful):

- Training of agents and home office personnel. This can be accomplished both through actual training courses and clearly written material.
- The clarity of the material mailed to the policyholder.
- Good data processing, mailing and printing facilities.
- The availability of a toll-free number for inquiries.
- The acceptance by the marketing division of a responsibility for achieving the company's goals. (Often these programs are developed by the corporate side of the company and the marketing side stands back and does not actively participate.)

Which Program Should You Adopt?

I have mentioned a few times the need for a financial analysis to test alternative programs under different sets of assumptions. Other important factors to be considered when deciding which program to adopt are:

- What is your company trying to achieve?
    - Equity
    - Preserve (conserve) the value of the company
    - Please the distribution system
- What will be the likely attitudes of:
    - The field force?
    - Branch managers?
    - Staff?
    - Shareholders?
    - Policyholders?
    - The public?
- How long will it take to implement the various strategies, how much will it cost from an administrative point of view, and what other actions may be required?

To conclude, I would like to ask everyone the following questions:

1. In view of falling interest rates, an active existing business program is likely to be cheaper today than it would have been 18 months ago (ignoring the financial losses from policies lapsing and being surrendered in the interim). Will it be cheaper or more expensive in 18 months' time?

2. Does an increase in lapses and surrenders improve or worsen your company's financial statement?

3. Who in your company, if anyone, is responsible for conservation?

MR. PHILLIP B. NORTON: The subject of our discussion, retention and replacement strategies, offers us an interesting challenge. There are two kinds of replacements--good ones and bad ones. If we are the replacing company, we've done a service to the customer and to our agent. If our business has been replaced, we have been victimized by unethical shysters whose right to exist should be questioned.

The recent rise in popularity of what we call "interest-sensitive" or "current assumption" plans causes us to view our own company's existing business as a bank vault that must be guarded and another company's business as a crop ripe for the harvest. As our discussion topic suggests, most of us must be prepared to look in both directions. Like the mythical Janus, two faces would help.

My specific task this morning is to discuss how universal life and similar products impact inforce business. First, let's look at the internal challenge. How can we manage an existing inforce block when we begin to offer these products?

A recent Best's article indicates that over 150 companies now offer a universal life product. These companies tend to be the younger, smaller stock companies. More established companies have shied away from universal life because of the potential impact of the availability of such an interest-sensitive product on the company's existing business. The specter of rewriting large portfolios of profitable business is scary, but potential replacement cannot be overlooked.

The first question company management must ask itself is: "Why are we offering this product? Is our strategy to be defensive or offensive?" This sets the tone and direction for all else. Long-term success probably means a consistent approach toward acquisition of new business and conservation of existing business. Our agents will have little patience with inconsistent practices. The choice is clear and basic--if the new product is best for new policyholders, isn't it also best for existing policyholders?

In making the strategically critical choice outlined above, there are numerous risks to be considered. My list is not exhaustive but does highlight some of the more challenging factors that have to be recognized in the policy setting stage:

1. If you opt for a defensive strategy, did you misread your market? Do your policyholders want universal life? Will they go elsewhere?

2. How sophisticated are your policyholders? Are replacements likely to be agent initiated or customer driven?

3. Will the marketing organization support the strategy selected?

4. What are the cash flow implications? Can they be managed?

5. What is the likely financial impact of moving your existing business to a current interest rate basis?

6. What are the characteristics of the existing book of business?

7. What business is most likely to be rolled over?

8. If you are a stock company, there are GAAP issues to be dealt with--including the treatment of deferred acquisition assets for inforce business.

To put my remarks into proper perspective, you should understand that my company chose an aggressive, offensive strategy as our basic approach. We have taken a similar position toward the replacement of existing business. We have been writing universal life for over two years now, and we believe Lincoln Corporation affiliates may be the largest writers of the product with a combined production of just over $4 billion in 1982. While we have done some fine-tuning of our original policy, our basic strategy remains unchanged--make it worthwhile for the agent to keep the customer with us.

In making our choices at Lincoln National, there were internal and external factors to be considered. The internal considerations will be different for each company. Among those that were related to our decision were agent control issues. As a career agency company, primarily, we think we have a reasonable amount of control. However, there are limitations. For example, we have found that agents tend to move recently written business. This information helped set our policy and procedures for dealing with the inforce as well as new business.

In the final analysis, our options for controlling the agent are limited. Faced with restrictions he does not respect, an agent will simply take his business down the street. In our experience, the agency head is most effective at managing activity and results. As an aside, it should be noted that recent LIMRA studies suggest that agent recommended replacements account for only one-third of all replacements. Two-thirds is customer driven. "Sell it and forget it" is not a good management strategy for inforce business.

Avoidance of excessive rollover of older, high margin business is of critical concern. No company can afford mass replacement of existing business without serious earnings impact. Whether a company chooses a defensive or offensive strategy, prudent management will set realistic limits on how much surplus can be sacrificed to support universal life rollover. Monitoring becomes a critical activity, whether following an individual agent's replacement activity or the cash out position of the company. Since the liquidation of assets is not involved in internal rollover, the disintermediation problem is reduced. In our case, the primary effect of rollover is to move business from the par line to the nonpar line.

Management must be prepared to take immediate action in order to follow the established plan. Set financial limits up front. Manage closely to those limits. Be prepared to exercise tighter agent control. Monitor the proportion of an agent's business which is replacement. Revise replacement rules, commission levels and underwriting practices to avoid exceeding the anticipated financial strain.

Much could be said about how the characteristics of the inforce business shape decisions to manage the block. Age of the business, participating or nonparticipating status, policy size, and policy design each offer specific challenges. In my own company's decision, large volumes of newly written participating business were influential in setting our direction. We designed commission rules that anticipated a relatively large number of rollovers of existing policies; full commissions are paid provided the new universal life face amount is at least two times the face amount of the replaced policy. All cash values are rolled over to the universal life policy. The new premium is at least equal to the current premium.

Currently, 80% of our new business is universal life. About 40% of those universal life policies are internal replacements. This percentage has pretty much stabilized. The typical replaced policy is around five years old and is participating (65% of our replaced policies are between five and 10 years old; 79% are participating). Eighty percent of rollovers represent at least an equal amount of premium as the replaced policy. Only 18% of replacement activity involves business written in the last three years.

To date, most companies have chosen a somewhat more defensive posture toward inforce business. Consequently, they have designed more conservative controls, primarily in commissions and credits for rollover cash values.

Another type of strategy aimed at internal replacement of existing business is emerging. Given the persistency and mortality nightmares that have developed in the wake of the select and ultimate term era, several of the large writers have begun aggressive programs to exchange term products for newly introduced universal life products. This effort will be especially interesting to watch. Historically, conversions are important when products are being developed, but are seldom heard of in practice. Given the significance of the select and ultimate term lapse rates, the motivation to press for conversions may produce better results than we have seen to date.

Let's shift to external replacements for a moment. Whether you choose to view this type of replacement as a threat or as an opportunity, an unethical practice or a moral obligation, one way or another we all do it. Though our statistics are not entirely reliable, around 10% of our universal life business is admitted replacement of another company's business. This is reasonably typical experience, although it is no easy task to get reliable intercompany data on this point.

In recent months, an especially controversial replacement approach has emerged and is gaining momentum if not respectability. Appearing first almost as a whisper campaign in a few specialty companies, limited evidence conversions of policies in force with another company are now being discussed in polite company. As could be expected, "conversion" of term business to universal life quickly shed its timidity. There is now a full-blown aggressive replacement campaign for permanent inforce as well. For example, one major company offers its universal life as an exchange basis for business inforce in other companies for up to $1 million, standard to age 65, with no new evidence of insurability. You will hear more about this phenomenon in the months ahead since there are some half dozen national companies who now have similar programs.

To summarize, it seems clear that as new products are introduced, a company will either devise a deliberate strategy for managing its existing block of business or will have an unmanaged reality thrust upon it by the volatile marketplace. At Lincoln National the choice was between an update program or universal life rollover. In our situation we felt a relatively small and newly written block of par business was vulnerable. The amount to be spent upgrading benefits was quite high relative to the results anticipated. Additionally, we believed universal life to be a good product. We chose universal life instead of update as our answer to the retention challenge.

MR. ROBERT G. CHIPKIN: I'd like to discuss mutual company retention strategies for traditional policies, as evidenced by the update programs that have evolved over the past several years. It is important to recognize that these update programs are attempts not only to refine and improve, but also to retain traditional life policies as traditional life policies. This is fundamentally different from "self-replacement" strategies (rollover to universal life or exchanges for current series policies). Update programs imply a commitment on the part of the mutual company to the thesis that the traditional life policy is a viable, long-term insurance vehicle, and will continue to serve both the policyholder and the company well.

Let's look at the types of lapses that could be prevented by update programs. A recent LIMRA survey indicated that approximately half of all policies that lapsed did not replace with new insurance; of the other half, approximately two-thirds lapsed and replaced while the remaining one-third said they intended to replace. Since update programs are primarily product oriented, they are only effective on the margin; that is, in lapse situations where product competitiveness and attractiveness are important. Such programs do not address those policyholders whose reasons for lapsing include:

1. Retirement or other economic reasons.

2. Poor quality of service from the agent/company.

3. An inappropriate initial sale, including (but not limited to) buyer misunderstanding or ignorance of the product and other available options.

Additionally, update programs do not address specific individual policyholder needs. Their focus is improvement of product benefits in general and in a specific way for all policyholders. Naturally we should not expect all policyholders to agree with us in the particular benefit improvement offered or even that the program is an "improvement".

None of this is intended to suggest that update programs are ineffective--merely that they cannot be considered a total "solution" to a company's persistency problem. They must be part of an overall strategy to prevent lapsation.

The first type of update program that I would like to discuss is the guaranteed interest rate update. Companies introduced products in the early '80s at guaranteed rates of 4% or 4 1/2% that recognized (in dividend scales) the more favorable after-tax investment returns under Phase I of the 1959 Tax Act. Potential update schemes were described in "Updating Existing Life Insurance Policies" by Dyer, Murphy, and Reiskytl (TSA V. 32).

A typical update approach includes:

1. A benefit increase varying with issue age, duration and type of insurance plan.

2. Equality of terminal reserves as of the update offer date.

3. Maintenance of the guaranteed premium schedule, thereby reducing unit premiums.

4. A new pattern of guaranteed cash values reflecting the new guaranteed interest rate and face amount.

5. A new pattern of annual dividends.

Some reasons for guaranteed interest rate updates are:

1. Replacement/lapse problems (including self-replacement); lower premiums or better "return".

2. More "modern" basis (in the eyes of policyholders).

3. Tax effectiveness of the policies.

4. Sales opportunities for agents.

5. Public relations.

6. Ancillary objectives (e.g., increase policy loan rates).

My own company instituted an update program in 1982 for those inforce policies whose guaranteed interest rate was less than that being offered on our current series. We structured the offer so that a "negative affirmation" approach was possible; that is, a policy would be updated unless the policyholder declined in writing. This approach was made possible by guaranteeing policy benefits (but not necessarily dividends) that were at least as great at all future durations under the updated policy as they were under the original policy.

Our reasons for using this approach rather than a bilateral offer and acceptance were twofold:

1. To reduce the mortality anti-selection inherent in a program that increases policyholder amounts at risk at the policyholder's choice.

2. To reduce expenses associated with the update program.

We were very successful with this methodology (less than 1% rejections).

Using the negative affirmation mechanism, we could not complicate our offer by including a policy loan rate increase as part of the update program. Several companies did update, or are in the process of updating, their inforce on a combined guaranteed interest rate/policy loan interest rate increase basis.

Under Stopgap tax legislation, company interest in guaranteed interest rate updates has declined. For a company whose dividend scale is based upon Stopgap, the effect of such an update on dividend interest rate increments would be about 50% of what it would have been under Phase I of the '59 Act.

A second type of update program has surfaced in the last year or so. It is the policy loan rate/dividend methodology update.

Prior to 1982, mutual companies based dividend interest rates for various dividend classes on a weighted average of their nonloan portfolio rate and their guaranteed policy loan rate. The weights were based on the actual or anticipated policy loan utilization of each class. Since nonloan portfolio rates exceeded guaranteed policy loan rates, and dividend interest rates were constant for all members of a dividend class, there was a subsidy of earnings from nonborrowers to borrowers. Continuing deterioration of policy loan experience would have reduced dividends calculated by this method. However, the recent overall improvement in nonloan portfolio rates masked this effect.

In response to this, many companies began to introduce new traditional policies with a variable policy loan interest rate. This was made possible by the now almost universal adoption in the U.S. of some form of the NAIC Model Law allowing for an adjustable policy loan rate based upon Moody's long-term bond index. Dividend interest rates used for illustrations are based upon the company's nonloan portfolio rate. Projected dividends are improved considerably over comparable fixed policy loan interest rate policies.

Almost simultaneously, Northwestern Mutual introduced a new policy series with a fixed policy loan rate of 8%, but with a change in dividend methodology. This methodology, direct recognition of policy loans, was outlined in the paper "Policy Loans and Equity" by Kraegel and Reiskytl (TSA V. 29). In this context direct recognition means an adjustment to policyholder dividends, on a <u>policy-by-policy basis</u>, that explicitly recognizes the difference in investment earnings between policyholders based on that year's loan activity. Dividends to nonborrowers are based upon the company's nonloan portfolio rate. The adjustment for each borrower is the product of the policy's average loan balance for the year and the difference between the dividend interest rates for nonloaned and loaned funds.

With the introduction of these changes for new issues, some companies began planning for an update of their inforce. The reasons advanced for a policy loan rate/dividend methodology update were similar to those advanced for the guaranteed interest rate updates, but with a subtle change with regard to the "retention" of inforce. The emphasis moved from retention of policies to retention of nonloaned assets. It was recognized that policyholders without loans were subsidizing those with loans. Their policies were the more profitable. Moreover, borrowing or lapsation of policies with little or no loans could cause substantial capital losses in today's interest climate. Therefore, the emphasis in the policy loan rate/dividend methodology updates evolved to offers that would:

1. Attempt to protect inforce assets by improving illustrations on nonloaned policyholders.
2. Produce better equity between borrowers and nonborrowers.
3. Give companies somewhat better protection against future financial anti-selection resulting from policy loans.

The potential combinations of policy loan rate/dividend methodology come from:

1. Policy loan rate
   a. Continue existing rate.
   b. Change rate to 8%.
   c. Introduce a variable loan rate (VLR).
2. Dividend calculation methodology
   a. Continue class adjustment for policy loan activity.
   b. Direct recognition of policy loans on a policy by policy basis.

The first strategy I'd like to discuss is the combination which continues both the existing loan rate and current dividend methodology--the so-called "do-nothing" strategy. Since interest rates have come down from their peaks of the past several years, this strategy may work. However, I'm reminded of the story of the little old lady, slowly crossing the small country road with her bundles in hand. When she had reached the middle of the road, a sports car came over the top of the knoll at 90 miles per hour. She continued her slow walk, and the car zoomed past and missed her by a hair. The driver slammed on his brakes and then slowly pulled back to her. "Lady", he said, "why don't you watch where you're going?" To which the woman replied, "Why? Are you coming back again?"

The point of the story is that existing policy loan rates and dividend methodologies will not give companies any additional protection against policy loan disintermediation if an interest rate "spike" should come back.

The next possible strategy that I'd like to discuss is the VLR only update. The policyholder is asked to exchange his fixed loan rate for an adjustable (and currently high--between 12% and 13%) loan rate. Illustrated future dividends are usually substantially higher than those for his current policy. From the policyholder's perspective, the pertinent questions will be:

1. Is my increase in dividends (presumed to be tax free) greater than my increase in after-tax loan costs?

2. What personal financial risk do I place on a variable policy loan rate?

For VLR only policies, policyholder equity is consistent (with respect to the policy loan and dividend mechanism) with:

1. Dividend interest rates based upon the nonloan portfolio rate, and

2. Long-term investments.

My reasons for these assumptions come from two observations. First, increases in assets from policyholder premiums, whether paid in cash or by new policy loan, earn a comparable rate. This assumes the Moody's index is a reasonable approximation for the company's new money rate on new long-term investments. In addition, when a policyholder forces the sale of a bond at the market rate of interest, to secure a policy loan at the VLR rate, the company acquires an asset which, when combined with the gain or loss on the sale of the bond, has (ignoring federal income taxes) the same yield as the original bond held to its maturity date.

Given the current relationship between the Moody's index and most companies' nonloan portfolio rate, it is difficult to imagine that the offered increase in dividends to highly loaned policyholders will exceed the increase in loan costs, even after tax. Therefore, such an offer will only be successful with policyholders having little or no loan balances. Mass Mutual is currently going through a VLR update, and their preliminary statistics indicate that the acceptance rate for policyholders with any current loan balance is approximately 23%.

My own opinion is that ultimately, assuming continuation of sales of traditional products, most policies will be on a VLR basis. What we need for such an update offer to be more successful is an economic period where long-term new money rates are closer to portfolio rates.

At the other extreme of potential update programs is the variable loan rate/direct recognition strategy. Dividends to policyholders with loan balances are adjusted to reflect the loan interest actually incurred in a given policy year. This is done on a policy-by-policy basis. Again, given the current Moody's index, this adjustment will <u>increase</u> dividends to borrowers. Such an offer may be extremely attractive to borrowers. It becomes even more attractive as the VLR rate goes up because the resulting increase in dividends will probably exceed the increase in after-tax loan costs.

Because of the attractiveness of borrowing under such a policy loan rate/dividend mechanism, the appropriate investment philosophy for nonborrowed funds is very short term. This raises several serious reservations about this type of update:

1. First and foremost, do we want to make borrowers out of nonborrowers?

2. Are the company's assets so situated that they could absorb a large one-time surge in new policy loans? (At my company, we looked at nonloaned assets for policies designed for minimum deposit sales and still felt that additional one-time loans of that magnitude could cause serious capital losses and cash flow problems).

The other two updates I'd like to discuss are the Direct Recognition (DR) only and the 8% DR offers. These appear to be the most popular types of update currently being offered. From the policyholder's point of view, the continuation of either the current loan rate or a fixed 8% loan rate has a psychological comfort to it. Testing to see if dividend increases will exceed after-tax increases in loan costs will be done by policyholders and will result in the declination of the offer by those who are heavily borrowed. An 8% DR offer will probably be acceptable to a wider class of borrowers than the DR only update. The opposite will be true for nonborrowers.

The DR mechanism does not contemplate any capital gain or loss in the making of a policy loan. This implies a short-term company investment strategy. However, I suspect that companies offering this type of update will continue to use a "mixed" investment strategy of both long and short vehicles and to adjust their policy loan liquidity needs on a year-by-year basis. The DR mechanism does give companies and nonborrowers better financial protection against policy loan disintermediation than the structure prior to DR. However, if we hit another sudden interest rate surge, companies with DR mechanisms and long-term assets may have to decide whether to charge the capital losses resulting from new loans to borrowers or to borrowers and nonborrowers alike.

The final item that I'd like to consider is the future status of nonupdating policyholders. As a class, under any of the policy loan/dividend methodology update options, they will almost certainly have a higher policy loan utilization rate than they had prior to update. They will be primarily the policyholders who were subsidized under prior dividend mechanisms. Since these update schemes try to eliminate subsidies between borrowers and nonborrowers, we are presented with a problem. Companies are reluctant to reduce existing dividend scales; therefore, nonupdating policyholders are probably being offered the current scale. For most companies, this means a conscious choice of a subsidized scale for this class of policyholders for some time to come. This is a substantial cost of update offers, and it should not be ignored when contemplating such a program.

MR. NORTON: Having told you earlier how to run your business, I now want to tell you about some problems that have developed for reinsurers--partly as a result of our not managing our business as well as we should. These problems have implications for your retention/replacement planning.

Replacements, both internal and external, and retention efforts are generating some devastating lapse rate experience for reinsurers. Direct writers are affected by this, too, but reinsurers generally are impacted to a much greater degree because of the disproportionate share of the persistency risks we have allowed ourselves to assume.

Like others in our industry in recent years, reinsurers have allowed astounding production increase numbers to turn the spotlight from what was really happening. In our quest for market share, we became party to and principal supporters of questionably designed products and sales practices. I could site the example of deposit term. We have had very high first-year lapse rates on a product which should have excellent persistency. Part of this is undoubtedly due to product design--specifically, high annualized first-year commissions. First-year lapse rates in excess of 30% on a plan that is supposed to be lapse proof illustrate my point.

The prudent reinsurer is reexamining existing blocks of business and the impact of excessive mortality and lapse rates on those blocks. That reexamination will likely cause reinsurers to exercise more caution in accepting new business. They cannot continue to ignore these developments and, if they have not already done so, will surely be approaching you with some sad tales that must result in higher reinsurance costs. Pricing distinctions between automatic and shopped facultative business are a predictable result. Margins on automatic business are no longer adequate to subsidize underpriced shopped business.

Select and ultimate term, or reentry term if you like, is the worst culprit. Graded premium whole life plans are a close second. Very low first-year premiums that rise sharply in renewal years did exactly what they were designed to do--made it very easy to sell large volumes of business on the basis of low initial cost and high first-year commissions. Reentry works reasonably well for the good risk, who either reenters or switches to another company with an even lower first-year rate and a new first-year commission for the agent. The poor risks, to no one's surprise, persist and contribute to poor mortality results.

The Intercompany Large Amount Mortality Study shows significantly higher mortality on term than permanent--probably due to selective lapsation.

1973-78 INTERCOMPANY LARGE AMOUNT MORTALITY STUDY
RATIOS OF ACTUAL TO EXPECTED DEATHS BASED ON 1973-1978
STANDARD ORDINARY ISSUES EXPERIENCE

BY DURATION AND PLAN OF INSURANCE

POLICY YEARS	PERMANENT PLANS	TERM PLANS
1 - 2	96%	96%
3 - 5	91	98
6 - 10	91	105
11 - 15	88	99
16 - 20	93	94
21 - 25	88	90
ALL	91	98

I direct your attention to years 3 through 15. You can see the significant mortality results in term versus permanent plans. We believe this to be the result of selective lapsation--specifically, financial anti-selection.

The high first-year lapse rates associated with most term plans are a familiar and serious problem. However, there is another problem that seems to have received much less attention and yet may be even more damaging to long-term results. That is that renewal lapse rates on most renewable term plans are almost as high (sometimes higher) than first-year lapse rates. High renewal lapse rates are certain to reflect selective lapsation, which will lead to a deterioration in long-term mortality results.

LINCOLN NATIONAL LIFE REINSURANCE LAPSE RATES BY SIZE OF POLICY ISSUED
BY CLIENT COMPANY
1976-80 ISSUE YEARS EXPOSED TO 1981 ANNIVERSARY

COINSURED TERM PLANS ONLY

Policy Duration	$250,000-499,000	$500,000-999,000	$1,000,000-Up
1	18.7%	20.5%	19.0%
2	21.2	24.2	25.4
3	19.4	23.3	22.3
4	19.5	22.8	27.3
5	17.8	(31.9)	(34.7)

( ) indicates fewer than 35 policies lapsed

I'd like to bring up three points here. First is the actual level of the lapse rates. They are higher than anticipated. The second item is the pattern of these lapse rates by duration. Notice that they do not tend to improve with duration. Finally, the lapse rates tend to get higher as the amount of insurance increases. This is the term pattern; it is quite different for permanent plans.

Mercifully, this product is so bad, and most reinsurers have been burned badly enough, that drastic changes will have to be made before select and ultimate plans get much new action. One leading writer of this product tells me their production on this plan is down 50% since commission adjustments were made at the insistence of reinsurers. The market is being impacted.

These changes come at a time, as we discussed earlier, when direct writers are busily developing procedures and plans for rollover of existing business. This is probably in the best interest of the policyholder, but we should do this with full recognition of the changed characteristics of the remaining block of old business (since the better risk moves to lower premium plans). This leads us finally to a related direct/reinsurance issue involving replacement and retention of our inforce.

When moving existing business to new plans, do your companies a favor and make certain the reinsurance of such policy exchanges is handled properly. When internal replacements are involved, many reinsurance agreements, and the preponderence of industry practice, hold that without full new evidence of insurability the new policy stays with the original reinsurer even though that reinsurer may not otherwise be accepting new business on the plan. This principle of continuation of coverage has long been an industry practice, but many reinsurance treaties are either silent or imprecise on the subject. My suggestion to you is to develop a clear, written understanding with reinsurers as a part of your checklist when an internal replacement program is being developed.

Now let's look briefly at external replacements. For this discussion, let us divide external replacements into two categories:

1. Those where new evidence is obtained, and

2. The limited evidence exchange programs described earlier.

Both have reinsurance implications that deserve some attention.

In response to the frequent movement of business from one company to another, reinsurers have taken the lead in efforts to control such movement of large policies. At my company, we have instituted a program of charging for the persistency risk this business represents. Most reinsurers have adopted similar programs. Some will not accept these replacements at all. The situation is improving. There are indications that more and more direct writers are making some effort to add persistency to the risk selection criteria. Some companies are passing along the persistency surcharge to the policyholder which, if it sells, should help improve persistency by increasing the insured's investment in the policy. My question to you is, what are you doing to prevent your company from being this year's warehouse for an agent's annual commission crop?

The second category of external replacement is the newly developing "limited evidence exchange" program which was referred to earlier. As this practice emerges, each new entrant seems to offer broader and more liberal benefits. The first programs were limited to term to permanent conversions, but this has now been expanded to include conversions from permanent business and for amounts as high as $1 million. We feel overinsurance is a key concern, and somehow termination of the existing coverage must be a condition for acceptance of the new issue.

Like the direct writers, reinsurers are watching developments carefully; they are not too eager to be viewed as "supporting" this controversial approach. Some are shouting "Unclean! Unclean!" in public, but in private are providing facilities. My caution to you is to make sure you have reinsurance facilities compatible with your offering while still in the planning stage.

Perhaps that is a good place to stop. I have shared some of the skeletons from reinsurers' closets since some of them are likely to haunt you (if they haven't already). To end on a more optimistic note, there may be a positive aspect to all this travail. If higher reinsurance costs force an increase in gross term insurance rates, pressures for replacement should subside and perhaps improved persistency on existing business as well as new business would result. If, as we are accused, reinsurers led us into the problems discussed, perhaps we should exercise some leadership in heading us back to a more reasonable marketplace--a marketplace where survival does not look like such a bad idea.

MR. JOHN E. TILLER, JR.: Phil, I'd just like to point out that when you get your lapse data updated for 1982 and 1983 experience, I think you will find it is even worse.

MR. BERNARD RABINOWITZ: I have a question for Charles McLeod. Charles, you mentioned that only two U.S. stock companies are engaged in exchange activity. What type of exchange is it? Is it par to non-par? How does it differ from what the mutual companies are doing?

MR. MC LEOD: What I said was that only two stock companies had implemented unilateral enhancement or bilateral update programs. A number of stock companies have exchange programs.

MR. THOMAS E. SKILLMAN: I have two questions. The first one concerns Northwestern Mutual's Update '80 program. My understanding is that the attractiveness of the update was largely related to the tax situation of Northwestern Mutual. That is, the tax savings were expected to be sufficient to support the administrative costs as well as give additional value to the policyholder. My question is whether the update project would have been viable if the proposed life company tax legislation would have been in effect two or three years ago.

MR. MURPHY: I will try to answer, but I have not really had a close look at the new tax law. I tend to agree with the comment that Bob made during his speech indicating that the savings that might have been there under the '59 Act were probably cut in half under Stopgap. To some extent, the new tax proposal has some similarities to Stopgap; so the tax advantage may be similar. In Northwestern Mutual's program, the tax savings from the '59 Act balanced out pretty closely against the mortality cost involved so that the dividends were not affected dramatically. To undertake such a program now might involve a further lowering of dividends. This might cause you to do a bilateral update rather than a unilateral update or negative enrollment.

MR. CHIPKIN: I'd like to add something. Guaranteed interest rate update programs are possible to do even without any tax savings. One of the attractive features is that you have a third party bearing some of the cost. From my own reading of Stark/Moore, I suspect that interest rate differentials, if they exist at all, will be extremely small; certainly nothing compared to either Stopgap or the '59 Act under Phase I.

MR. SKILLMAN: My second question is for Phil. You mentioned that 79% of internally replaced policies are replacements of par policies. My understanding is that Lincoln National has long been a supporter of the par concept for permanent business. How does the 79% relate to the percentage of your permanent inforce that was par prior to the introduction of your universal life product?

MR. NORTON: In the last seven or eight years Lincoln National has been essentially a par company writing par business. This business fit the pattern that we anticipated to be vulnerable, and so the whole thrust of our replacement strategy recognized that fact. However, the par business represents a relatively small proportion of our overall inforce.

MR. ROBERT C. TOOKEY: I have a question for Phil. Does Lincoln National now have an enhancement program, or are you considering an enhancement program, for non-par whole life policies?

MR. NORTON: Bob, to my knowledge we do not. Are we considering it? I have made the remark that we do not know how far into existing business rollovers will go. I have to assume that there is probably a project panic sitting on the shelf someplace if it goes other than planned.

MR. ROBIN B. LECKIE: I heard something from one of the panelists this morning that troubles me. I guess we have all had some troubles as actuaries, in the past few years, reconciling ourselves to replacement, switches, and new marketing methods. We try not to keep our heads in the sand, but when I hear of a strategy aimed at replacing participating business with new nonparticipating business, I think we have to ask ourselves some questions.

To avoid being a preachy actuary, I think I would rather look at this as though I were a class action lawyer. Consider those par policyholders who had their policies inforce for three to five years and then were encouraged to swing over to a universal life type policy. Now the par policies only made sense in the first place if they were sold on a long term basis. If these policies were not intended to be long term, they should have been non-par. Whether or not that is why the policyholders bought them, or whether they understood that that was what they bought is rather immaterial. Somewhere along the way, though, it is decided that these policyholders didn't do the right thing and they really ought to be in something short term. Universal life is a short term product with short term investments. And so these policyholders were encouraged to move to universal life. Not only that, but the person who encouraged this move got a new commission for it. I do not know that the policyholder realizes this.

Now suppose interest rates turn down. The participating policy was self-adjusting, at least after those initial acquisition expenses were amortized, and the old long term policy really would have been a much better value (particularly taking into consideration the various options that existed with the contract). As a class action lawyer, I am quite interested in going back and reviewing with those participating policyholders the action that company took in swinging me over from what was really quite a good contract into what might now appear to be a poor contract. I wonder if we thought this one through.

MR. BRUCE E. NICKERSON: I'd just like to make an observation about programs that involve one company exchanging another company's policies. The information we have is that the company that pursues this type of program either has provided a lower level of compensation to the agent on such an exchange than on clean new business, or has provided a lower value to the customer than on a normal new policy. This is done to recognize the fact that there is not recent or immediate classification of the risk.

Since a number of our competitors have been following this strategy, we took a look at it. We questioned some of our agents and got the response that they would love to have us follow a similar strategy since we were losing business to these other companies. But on inquiring a little further, we discovered that when the individual for whom the agent was performing the exchange was unquestionably a good risk, the agent opted for an exchange that involved a medical examination, normal pricing and compensation. This should be kept in mind both by companies who are considering such a program and by reinsurers.

MR. NORTON: I've heard of a number of companies investigating this, particularly among the brokers. Bruce, I think you're right that we should exercise caution.