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LOOKING TO THE FUTURE OF LIFE INSURANCE

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- o Washington outlook
- o Social research projections
- o Outlook on future format of the financial services market

MR. RICHARD S. SCHWEIKER: I've heard actuaries described as the engineers of the life insurance business, and I guess that's a pretty good description. You are the ones who set our prices, establish our reserves and really determine whether we can do business at all or whether we can make any money at it.

I've also heard that the one thing you could give an actuary to make his job easier would be a reasonably stable environment -- a political system that didn't fluctuate wildly, and an economy that had some degree of certainty to it. I wish I could give you that kind of reasonable, predictable environment, because it would not only make your lives easier, but obviously would make my life a lot easier at the ACLI.

But in the absence of magic or the power to make dreams come true, we have to rely on plain old hard work. This is certainly true at the ACLI, and it is

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particularly true with respect to one federal issue that has dominated our activities for the more than three years I have been associated with the industry -- taxes.

Before I mention that, though, I do want to say one other thing that would be of interest to you. One of my jobs was Secretary of Health and Human Services. I managed to be at the helm of that particular job right in the middle of the big Social Security crisis. So I learned first-hand, because Social Security was under my domain, what actuaries are all about, in terms of the Social Security fund, in making predictions and projections. As you may recall, Social Security was heading towards bankruptcy at the time the Reagan administration came into office, and our job was not only to avert bankruptcy, but to get Social Security back in the black. I happened to have a very high respect for the actuaries at Social Security. I think they have done an outstanding job over the years. The complication, however, was that we also had back then a director of the Office of Management and Budget named David Stockman. He took a little bit of editorial license about the predictions and the assumptions and the revenue estimates that you actuaries had produced, and the result was that the first Reagan proposal for Social Security got shot down. And then, unfortunately, the situation polarized for a couple of years while Democrats and Republicans chose up sides to be the greatest protector of the fund. Finally, it got back on the track a couple of years later. I guess the moral of the story, in addition to my learning the hard way about actuarial assumptions, is that you folks wouldn't have any trouble in your job if you could just get the managers to stay out of your business. I certainly found out that changing actuarial assumptions is a very risky business, one that obviously had some very heavy fallout in terms of the Social Security problem.

As I mentioned, I do want to talk for a little while about taxes. We all thought back at the time that I became head of the ACLI that when we passed the 1984 Life Insurance Tax Act, all of the work was done for this bill and in this area for at least a dozen years. Of course, we couldn't have been more wrong, because at the end of 1984 the administration unveiled still another total tax reform proposal that would really have knocked the life insurance industry for a loop had we not been prepared to deal with it.

LOOKING TO THE FUTURE OF LIFE INSURANCE

There's no question in my mind that the original tax reform proposal -- Treasury One -- was a fundamental threat to the survival of our industry as we know it today. From a tax standpoint, it was probably the greatest challenge to the life insurance industry in its history. Just imagine what the life business would be like today had Treasury One been enacted into law:

- The inside buildup would be taxed for all of some 160 million present policyholders, as well as future policyholders.
- Health insurance benefits would be taxed.
- New additional limits would be placed on reserve deductions. You'd have a penalty for building up the kind of reserve that you need to be solvent.
- The $50,000 group life exemption would be eliminated.
- All 401(k) plans would be eliminated.
- The 20% TIA and small company deductions would be eliminated.
- All deferred annuities would be taxed.
- And there would be a tax on policy loans.

Not many of our companies would have been untouched by these proposals, and I suspect our actuaries would have felt that impact just as severely as anyone else. In fact, the Treasury's own figures, not the industry's, showed this would have meant about $100 billion of new taxes for the entire insurance industry over five years.

Fortunately, we were successful in our efforts to have the Treasury's proposals modified so that they would be far less harmful to our industry. In fact, as we examine the bill that is about to become law on the President's desk awaiting signature, we find that our industry has fared quite well. Perhaps the best news is that the tax-free inside buildup of cash value policies will

be allowed to continue, and there will be no health tax and no additional tax on reserves.

There are many reasons why we were able to be successful on this issue, but one of the most significant was the fact that we had good advance planning. We had an issues strategy group and an issues strategy plan very early on, and we used it as soon as the first early warning signals came in 1984. In fact, we made some very important decisions at the outset, even before Treasury Secretary Donald Regan announced his plan. I would like to discuss these briefly, because I think they give us a blueprint for the future about how to do the thing that you are interested in doing, which is to minimize the kind of political risk and governmental intrusion into the industry that can change the rules so drastically even retroactively, right in the middle of the game.

First, there was the important decision over timing. When should we act? Should we wait until after Treasury One and wait to see what the President did at the White House on so-called Treasury Two, or should we wait until Chairman Rostenkowski made his mark, revision number three? Or should we start right away?

Fortunately, we decided that the best defense was a good offense and that the time to act was immediately. So we didn't wait until the issue was with the White House or the Ways and Means Committee. We went to work right away. In fact, we even unveiled a commercial on television which some of you may remember before Treasury Secretary Regan even announced the bill back in 1984 at the end of November. It was the one with the pigeon pecking away at that loaf of bread. In fact, this ad got a lot of attention and was selected as one of the six best political ads of the year.

The point is, because we mobilized early we weren't caught unprepared by the original proposal or by later developments. But more importantly, we were able to influence the development of the issue in a positive way almost from the very beginning.

A second key decision was to combine the major issues. Instead of considering taxing the inside buildup, taxing employee benefits, and taxing 401(k)s as

separate issues, we combined them into one big issue. This was far more effective and had much more impact on the public, the media, and the Congress. The message we wanted to get across was not fragmented. We believed, and our research backed up, that most people did not want their financial and health security tampered with. To them, it was a simple issue. Therefore, we placed all of the various elements of the issue -- such things as the 401(k) and annuities and group life -- under one umbrella, and under this one umbrella we were able to mount a successful public advocacy, advertising and grass-roots lobbying campaign.

Another benefit of combining the issues was that we were in a better position to unite the industry in a gigantic effort to meet that tax threat. The various elements of the industry felt that they were all in this together, not fighting alone for their own selective interests.

A third key decision was a concentrated effort on our part to develop as much unity on the issue as possible -- both within the industry and outside the industry.

For example, we pooled the resources of the ACLI and the HIAA (the Health Insurance Association of America), our staffs, and our member companies' Washington representatives. We put it all together through a legislative strategy group that gave us the advantage of a coordinated, industrywide effort with maximum participation of everyone.

We worked very closely from the beginning with our agent groups. I think our united effort and close coordination brought us probably closer to our agent groups in this battle than we have been for a long, long time.

We also reached out to develop working coalitions with other groups -- for example, the American Association of Retired Persons (AARP), some 17 million strong. I argued with them that the tax on the inside buildup was really an age index tax, because the longer you held the policy, the more you'd have to pay as your cash buildup increased. Thus, senior citizens looking to minimize cash layout and cash expenditures would have a tremendous tax incentive to cash

in policies and avoid the tax on the inside buildup. AARP enlisted in our campaign, as well as some union groups and the Chamber of Commerce.

And finally, and probably most important of all, we brought the two major elements within our industry together -- the stocks and mutuals. Despite strong differences that could have driven a wedge in our attempt at unity, I'm proud to say that the stocks and mutuals overlooked their normal differences and worked together very harmoniously.

You may be familiar with some of the things that the industry did. In fact, I'm sure a lot of you, through your companies and your people, participated in them. Our advertising, our grassroots lobbying effort, our direct mail campaign that generated over 1,600,000 letters and cards to Congress, and other aspects of this campaign contributed to its success. I'm not going to go into detail except to say that everybody's helping to pull his share was the key. Frankly, when you see the hit that the real estate and the oil and gas industries got, had we not organized early, and had we not had that open time frame when the House worked on the bill from the end of November of 1984 to the end of 1985, we really wouldn't be in the position that we are today. Once that bill got to the Senate, the version written in the Senate was done in about three days with seven senators participating. And then the conference bill had so much momentum and so much media PR that in no way was there going to be any real change in the thrust of that. So our early decision was probably the most important of all.

Obviously, we didn't win on every issue -- we lost the interest deduction on policy loans; we did have the 401(k) plans reduced but fortunately not eliminated. I suspect that with the IRAs taking it on the chin, 401(k)s will look even better even though they have a reduced limit. But compared to the real survival issues that were in Treasury One and Treasury Two, we really came off very well by comparison.

Now with tax reform behind us, action at the federal level, we hope, will quiet down a bit. But we still face uncertainty in our struggle with competitors in the financial services market. We still face threats to the risk classification system. In fact, we also agreed at our recent ACLI board

meeting to launch a risk classification attack in this area to explain and defend and espouse the principles of risk classification, which I'm sure you'll be hearing more about. We also are under attack from the liability crisis rubbing off on us because of the generic idea that all insurance has some problems. The fact is that the commercial liability portion that is under media coverage and intense scrutiny today represents only 2.5% of the total premiums paid in the life, health, auto, and homeowners industry. And I think when people talk about repealing McCarran-Ferguson or regulating everything from the federal level, we ought to remind them that 97.5% of the industry is working reasonably well. And while there are problems, obviously, with the other 2.5% -- severe problems -- we hope they also put it in the right perspective.

In a sense, we are seeing some of the action that was swinging away from Washington and back to the states. It is from here some of the most serious threats to risk classification have come, whether from unisex rates or restrictive AIDS regulation. So while there may be a temporary letup at the federal level, there is going to be a corresponding increase at the state level that will require our best efforts to handle it.

I hope this showed our industry what has time and time again been demonstrated to many other industries; that a lot of businessmen get a little bit deluded about how to influence the future of their business. They think that if they simply pay attention to research and development, from looking at new products to getting automatic data processing up to speed in their own companies, and somehow don't think about the government and what it does, that everything will come out all right. The truth of the matter is that the government is a silent partner of business whether we like it or not. We had dramatic evidence of that in Treasury One and Two. How we deal and work with them is probably more important to the bottom line of your respective companies than anything you are going to do internally. So if we really want to insure ourselves against the risk of government intervention or government involvement, good government relations is probably the best kind of insurance that we can commit ourselves to and work at. I hope this will serve as a model for the future so that we will have the same kind of apparatus and response mechanism available again if government intervention does occur at the federal level soon.

GENERAL SESSION

By now, everybody is familiar with the baby boom generation. Much less familiar to us than the baby boom generation, but no less important, is the generation just one step ahead of the baby boomers. This is a group that our social researchers and demographers call the prime lifers. They are the people in the 50-65 year old age group -- my group, I might add.

The Council surveyed this group in conjunction with the Gallup poll and some other groups last year to learn about their attitudes and perceived needs as they prepare for retirement. What we found out has tremendous repercussions and ramifications for our industry, not only in the years ahead, but right now. I know that many of you, because of the statistical and actuarial work you do, probably have touched and worked with these figures. But we try to extrapolate them one step ahead in terms of what the attitude will be, where the products might be, and what the industry is going to have to do to meet that senior citizen boom that obviously is upon us.

We discovered that because an important demographic shift has taken place in our country, an important change in attitudes has occurred as well.

The fact is, as you well know, Americans are living longer than ever before -- of course, your own research has been telling you that for some time. Because of these increased numbers of older citizens, there are different concerns today about financial security than in the past.

Historically, people bought life insurance to protect the widows and orphans: their wife and kids. They were concerned about other people, principally their dependents. That concern still exists. But today people are not only concerned about their spouses and their children and what would happen in the event of premature death of the breadwinner. They are now very much concerned about themselves, because more than at any other time in our history, Americans are going to be living a long, long time.

Probably the most significant facts:

1. By the year 2000, prime lifers may expect to live a quarter of their life expectancy in retirement. Think that one through a little bit. Have you

done any thinking about spending a quarter of your time in retirement? Has anybody really conceptualized what that means to our society or what you are going to need as a breadwinner or a spouse or whatever to plan a quarter of your life in retirement? That's a whole new ball game for a lot of people, financial services and others.

2. The number of Americans age 65 and over will increase by about 36% between 1980 and the year 2000.

3. The nursing home population is expected to grow from 1.2 million in 1980 to about 2.2 million in the year 2000.

4. In 1971, there were two million veterans. By the year 2000, that number is expected to exceed 9 million.

The prime life generation may well be one of the last generations of Americans to experience the post-World War II ideal of the so-called "golden years of retirement" -- that is, many years of leisure marked by adequate income, health care and independence.

In fact, our survey discovered a great deal of fear and insecurity about the prime life generation's financial future. About 40% of those surveyed worry about becoming financially dependent upon others during their retirement and not having the financial resources to meet their basic expenses. Thirty-six percent worry about having enough money to buy the things and do the things that they really enjoy.

As you might expect, within this age group the ones who are worried most are the single women -- the widows, the divorced women and the women who have never married.

Another sign of insecurity is that about half the respondents don't believe that the Social Security system will be able to pay their full benefits during retirement. And of course, if one quarter of your life span is spent in retirement, you can see that some of those active workers are really going to be paying the bill. I remember as Secretary of Health and Human Services that

back in the 1950s about 16 people were supporting one retiree; now we are down to 3 working people supporting one retiree. And we are going to go to 2 working people supporting one retiree. This change has tremendous repercussions in taxes as to who's going to pay all those retirement bills.

There is also the fear of physical dependency caused by catastrophic illness. This, in fact, was the most frequently expressed worry among this age group. What happens to me and my family if I have that catastrophic medical problem?

And on top of all this lies a gross underestimation of the cost of living a long life. For example, either the respondents don't know or else they overestimate the funds that Medicare is going to pay for their health-related problems in old age.

Because of these changes and the fears and insecurities that accompany them, we believe we are standing on the threshold of an ever-increasing demand for products that respond to this growing need for financial security -- not just for dependents, but for policyholders themselves. That's the new part of the ball game. Thus, we think we will see a steady increase in the use of whole life, universal life, supplemental health insurance and annuities to cover these new needs.

I have no doubt that these needs exist and that they will only increase as our population continues to age. But the challenge for our industry, it seems to me, is to meet these needs effectively, competitively and economically, either before our competitors do or before the government does. If we fail to do so, I fear that the increasingly older population will turn to the government. With the growing political clout of this group, government is going to be very, very shortsighted about any vacuum or any shortage in the private sector in terms of rushing to meet their needs and their concerns.

The founders of the life insurance business had a mission, and that was to protect the widows and orphans of this country against the uncertainties they faced. This has been the basis of a very profitable business.

I believe it remains the basis of a profitable business, but the nature of the business has now changed, has grown, has become more complex. I further believe we will only be profitable in the future to the extent that we recognize, understand and pursue this changing mission with the appropriate marketing and sales tools, and with the correct products.

I'm very optimistic about the future of the life insurance business. I believe that as an industry we have matured and gained some valuable experience about the importance of good government relations, and I don't think we'll ever have to learn that lesson again because of what we just went through.

I also believe our industry is becoming more sophisticated in its planning and marketing of insurance products in a rapidly changing environment. Obviously, we are going to have to do more and more of that in the future to change our products to meet the great needs that I'be just delineated.

I salute the Society of Actuaries for your contributions to the life insurance business. And particularly, I congratulate you for maintaining such high professional and ethical standards for the actuarial profession. As the engineers of the life insurance business, you've helped build one of the greatest industries this nation has ever known. With your continued good work, your high standards, and your commitment to excellence, I'm confident that the life insurance industry will continue its leadership and growth for the benefit of our future generations.

MR. RICHARD S. ROBERTSON: We now have a major new tax bill. It represents a very different situation out there. I don't think many of us fully appreciate how different it's going to be, but we have not solved the deficit problem. What happens next? Are we going to get new taxes next year? What are our chances?

MR. SCHWEIKER: There's no question in my mind that an awful lot of whether the tax bill is really going to work or not hinges on your question. I wish I could give you a reasonably accurate and optimistic forecast. I happen to think we have tremendous problems in this area. I think those of us who worked closely with the problem really felt that the time to solve it was

either prior to or concurrent with doing a tax bill and before the President entered the last two years of his presidency. So I think that by electing not to solve the problem other than with what I would call blue smoke and mirrors this particular session, we really made our problem almost twice as critical next year. I guess the only optimistic note I can see in that is that with taxes and the summit and some other things out of the way, maybe the administration will make it really a top priority.

There is no way that you are going to balance the budget without really doing three things. One is to slow down the growth in military spending -- not cut it, just slow it down. Another is to slow down the growth in entitlement programs -- again, not cut it, slow down the growth. And the third, I believe, is some kind of a tax increase. I think it's a little bit like a troika. There's no way politically you could put one or two things through without putting all three things through together. That is the only political way you are going to get an acceptable answer to the deficit.

You know, the department that I headed up, HHS, has the reputation, historically, as being the largest spender in modern times, even ahead of the defense department. A lot of people don't know that. When I left there was about $275 billion in the budget; it's now up to about $325 billion. HHS is still ahead of defense. People don't understand that, and the HHS budget is growing. The reason it's growing is because Congress passes what we call entitlement law, and whether that's Social Security or Medicare or Medicaid, it requires money to be spent. So ironically, the HHS has the biggest budget in the country and probably the world. The HHS secretary can't control 95% of his budget, because that's dictated by Congress. So when you talk about balancing budgets and about cutting back appropriations, unless you are willing to bite the bullet on entitlements, as well as the other two sides of the three-legged stool, you are really not going to do anything. I think that to pull us out of the mud, it's going to take a bipartisan group much, I would suggest, like the Social Security Commission that got us off of polarity and off partisan politics . I just hope that we have the wisdom and courage to do that next year, even though we didn't have it this year.

MR. PAUL G. SCHOTT: I'd like to know the relationship, formal or informal, between ACLI and the American Academy of Actuaries, which is our lobbying and public relations group.

MR. SCHWEIKER: I would say that we have no formal relationship, but we certainly have an informal relationship. Richard V. Minck and the folks in government relations try to coordinate with the Academy on key issues of interest. Whenever we get a problem that basically has similar interests in the life insurance business, we do work with the Academy. Obviously, it depends a little bit on whether you are talking at the federal or state level, but I think the form is true. At this point, we have a very healthy and good relationship informally. I think that one of our programs has been to continue to increase that coordination in the future, because I think many of us recognize that we are all in the same boat on some of these issues.