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WHAT HAVE WE DONE TO OURSELVES? A DISCUSSION OF CURRENT PRICING PHILOSOPHY

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- In recent years, the pricing philosophy for life insurance products has undergone some substantial changes. This session will focus on why some of these changes have occurred, and their impact on actuaries and companies both now and in the future.

MR. J. LYNN PEABODY: Our panelists are three distinguished gentlemen. Our first speaker is Steve Radcliffe. Steve is the Vice President and Chief Actuary at American United Life. Steve is on the Society's Board of Governors and has been a frequent author in various publications. He had a recent article in *The Actuarial Digest* that is the basis of his talk.

Our second speaker will be Dick Robertson. Dick is the Executive Vice President at Lincoln National. He has had a very heavy involvement in the strategic planning development at Lincoln National.

Our third speaker will be Wayne Bidelman. Wayne is the Senior Vice President of Reinsurance at Security Life of Denver. He, like Steve, has been involved in pricing for about 12 years and will be speaking primarily on the topic of reinsurance and current pricing philosophy in the reinsurance area.

MR. R. STEPHEN RADCLIFFE: Let me set the stage with a problem that I run into more and more these days. In an August article in the *National Underwriter*, a

company announced that it is offering a new current assumption life policy that would pay a current guaranteed rate of 10.5%. Later in the article, it states that the policy was supported by investments in Government backed securities -- not junk bonds. For that same week, I looked up the rates on mortgage backed securities in a report that is prepared by Morgan Stanley. The highest rate that I could find was 9.5% for a bond with an average life of fourteen years. To top everything off, the last sentence in the article was, "Our rule is never to pay an interest rate on which we cannot earn a profit." Do you suppose that they just got the sign wrong on their interest rate margin?

This sort of information really confuses me. There are many things that happen in today's marketplace that just don't make any sense. I will attempt to better define the environment we live in. I do not purport to have the answer to the questions posed by our crazy marketplace, but I believe that a problem once defined is half-solved. My perspective is from fighting wars in the trenches for over ten years. First it was with reinsurance and now it is interest sensitive products. I will give you my impressions and thoughts with a few facts substituted for impressions along the way. This will be mostly a philosophical treatment, so you can let your actuarial brains relax and see if these ideas help you understand what's going on.

I suppose this talk might be somewhat controversial. It is mostly about change and change makes some people uncomfortable. However, my approach to solving problems is to lay them out on the table, even if they aren't pretty, and start talking. If we confront our issues directly, we will move from the stage of denial that there is a problem to actually solving the problem.

To further set the stage, I have a few quotes that I've collected which indicate that you might be on the verge of having a pricing problem.

> "Three companies quoted on this business and we came in eleventh."
>
> A Reinsurance Salesman

> "I think, with a few adjustments, we can make this product break even in 20 years."
>
> A Pricing Actuary

A DISCUSSION OF CURRENT PRICING PHILOSOPHY

"I can't sell disability income without *lifetime* your occupation coverage."

A member of your loyal field force

"Well, how are those other guys doing it?"

CEO

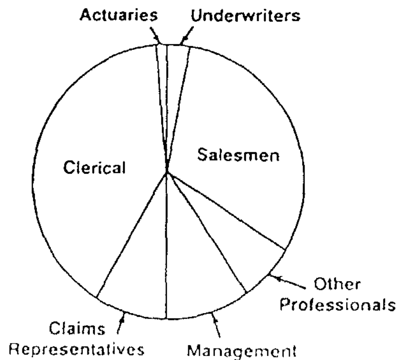
"Who in their right mind would trust insurance companies with their record of screwing the public?"

One of the other guys --
A. L. Williams

Now let's move on to what I have identified as the three main reasons for the profitability problem. Number one is an oversupply of insurance capacity together with an underdemand for insurance in the marketplace. Number two is that capitalism or free enterprise is not working to correct the imbalance mentioned in number one. Number three is that there is a lot of hysteria in the field force. We will spend more time examining problem number one because problem number two was discussed in my recent article in the *The Actuarial Digest.* The last problem is not a major one, but it makes solving the problems much harder.

With regard to problem number one, let's first examine the oversupply of capacity. Simply put, this means that there are just too many of us selling the same stuff. There are over 350 companies that sell Universal Life, and virtually all of the products are basically the same. In the Indianapolis yellow pages, I found that there were over 21 pages with about 1,300 phone numbers listed for insurance companies. Of course, this includes both casualty and life insurance providers, but it certainly presents an amazing variety for the consumer.

The following graph shows a breakdown of 2 million people that provide insurance services in our economy:



This graph was taken from a book entitled, *Invisible Bankers*, written by Andrew Tobias. The 2 million people include those in both the life and casualty business. I think there is an equal split of one million people for each industry. The point in Tobias's book was that we probably could get along with about half as many people to provide the basic insurance needs of our total economy. This is certainly an overstatement! However, he does make some good points.

The graph represents about half a million salesmen, and Tobias believes that we could do much better with substantially fewer in this sector of our industry. He also observed that we have been leaders in developing computers to do our tasks. This should have reduced our clerical force. What happened instead was that our tasks just became more complicated, and the clerical staff remained the same. Therefore, our unit costs actually increased instead of decreasing. He also believes that there should be a reduction in the management sector because there should be fewer insurance companies. With fewer insurance companies, there would automatically be fewer executives. By the way, the good news is that Tobias does not recommend a reduction in the number of actuaries. As a side note, from looking at this graph, it is hard to imagine the actuaries reaching the critical mass necessary to have the political clout to cause any change in our industry.

Now let's move to the problem of underdemand. The main point I want to emphasize is that over the past several years, the U.S. government through generous increases in the Social Security system has taken away much of the marketplace for individual life insurance. This problem has been exacerbated by the growth in group life insurance. The table below shows a summary of the Social Security survivors plus the group life benefits.

Social Security Survivors
Plus Group Life Benefits

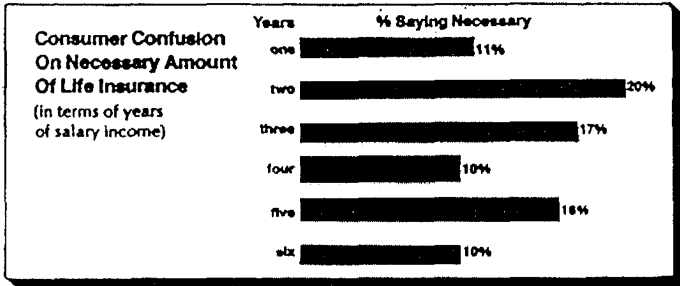
	Example #1	Example #2
Ages: Husband and Wife	30	40
Ages: Children	0 and 2	8 and 10
Salary	$ 30,000	$ 50,000
P.V. Social Security Benefits	$235,000	$170,000
Group Benefits	$ 60,000	$100,000
Total	$295,000	$270,000

I have shown this example for two different families. The Social Security benefit is a combination of a mother's benefit which is payable until the children are age 16 and the children's benefit which is payable to age 18 as long as they are in school. These benefits all add up to a maximum family benefit of $1,750 per month. In addition, there is a widow's benefit payable after the widow is age 65, but this is not a sufficient portion of the benefit.

As you can see from this table, the present value of the Social Security benefits plus group benefits of two times salary add up to nearly $300,000 of coverage for each family. In the first example, this covers the salary by 7.8 times, and in the second example, it covers the salary by 5.4 times.

Now let's look at what the consumer thinks he needs in terms of life insurance coverage. The following graph shows a recent survey which indicates wide variety of opinion about how much coverage is needed. The average of the graph is about 2.8 years. This presents quite a challenge for our agents selling individual life insurance. Most families have coverage between 5 and 7 times salary with the Social Security and group coverage. In order to sell any

individual insurance, the agent has to convince them that they need 10 to 15 times salary coverage. The consumer, on the other hand, thinks he needs about 3 times salary coverage. I can't think of a more difficult job than the life insurance agent's job in this kind of environment.



Source: Response Analysis - Interviews with 2098 households with incomes of 20,000 +.

The response to this squeeze of oversupply versus underdemand has been two-fold. In the first place, we have moved from selling life insurance to selling investment products. In the second place, we have concentrated on selling products with tax gimmicks. These include products like Section 79, Retired Life Reserves, Single Premium Whole Life and many others that have been concocted by the advanced underwriting sections of the Marketing Departments. In addition to using tax gimmicks, the tax law itself has been carving out several markets that have been serviced by the life insurance industry. These include products in the IRA, 401(k) and 403(b) markets. These markets have been a source of major growth in our industry in recent years.

The old way to sell life insurance was a three-step process. First, we established a need for life insurance. Then, we worked out the appropriate amount of coverage required. Finally, we worked out a payment plan. The payment plans included a wide variety starting with term insurance which is basically a pay as you go plan. For those who didn't like the increasing premium schedule of term plans, we offered level payments through some sort of whole life plan which included modified whole life and limited pay life. Most recently, because of its tax advantages, we have even offered single payment whole life.

This method of selling was precisely the foundation of the argument that we made to the SEC during the hearings of 1970 and 1971 to argue that the variable life insurance policy should be exempted from regulation. The basic argument was that the cash values were incidental and secondary to the method of premium payment plan chosen to fund the primary coverages which were death benefits. Of course, we lost the argument, and ever since we have been selling life insurance more like investments than we have death benefit protection.

The table below summarizes the differences between selling products in a life insurance industry versus an investment environment. The reason for preparing this table is to show the radical differences between the two.

Difference Between Environments for
Life Products vs. Investment Products

Life	Investment
- Long term contracts	- "Rolling" of funds
- High front end commissions	- Low level commissions
- Exempt from SEC regulation	- Usually regulated
- Complicated products	- Perceived to be simple products
- Difficult sale	- Easy sale
- Tax deferred income	- Primarily taxable income

What we have done in the industry so far is to sell investment products in a life insurance environment. The point to be made here is that if we continue to sell investment products, we will probably move closer to the investment environment. That would mean, among other things, lower and more level commissions, possible SEC regulation, potential taxation of the inside buildup and more churning of business. The right to sell life insurance is unique to our industry which we seem to have forfeited in our rush to sell investment products. Nobody else can sell life insurance, so I think we should concentrate on doing more of what only we can do.

The number two reason for our profitability problem is that the system of free enterprise is not working to balance the forces of supply and demand. Maybe it is working, but only very slowly, and this is what creates many of the unusual situations that we observe in the marketplace today. Let me briefly summarize some of the factors that I have identified which tend to blunt the forces of free enterprise:

PANEL DISCUSSION

1. Our financial statements tend to defer bad results, sometimes over many years. This is true for both GAAP and statutory statements. It may be that there is no way to avoid this problem. The source of the problem is that one of the most significant factors that go into the determination of current net income is the reserve setting process. Let me give you an example to illustrate this point. Consider the following income statement for an annuity line of business. The income statement looks like this:

	Amount in Millions
Premium	$100
Investment Income	90
Benefits to Policyholders	45
Total Expenses	10
Change in Reserves	125
Pre-tax Net Gain	10

The ending reserve for the block of business is $1 billion. Consider just a 1% error in that reserve. The effect would be to change the pre-tax gain by $10 million. Alternatively, the beginning reserve and the ending reserve would each be off by 1/2% in opposite directions and cause the same disturbance in the pre-tax net gain. The effect is that this small variation in the reserve can change the pre-tax net gain by 100%. By "error," I don't mean calculation error, but estimation error which is caused by making guesses which turn out to be incorrect for measuring the true future liability. Over a long period of time, these "errors" should cancel each other out. In the meantime, however, the results are blurred.

2. Many other industries can introduce new products with the hope of increasing market share and, therefore, profit. They can protect this profitability by patenting or copywriting these new products. There is no such protection in the insurance industry. New products are copied almost the minute they hit the street. Therefore, it is almost impossible to increase market share for any sustained period of time with new products. The result is that we all get on the new product treadmill and turn out a lot of new products without much reward. There are just too many companies trying to increase their market share with basically the same products to have any expectation that the system will be rational at the current time.

3. The insurance industry is regulated by a patchwork system of state insurance departments. This system worked quite well when the insurance industry was in a stable environment. However, in the 1970s and 1980s, the pace of change accelerated to where it seemed it was almost out of control. The state insurance regulators have had their hands full and seem to be fighting a hopeless task of managing this dynamic situation.

4. If a company goes bankrupt in a pure free enterprise system, the stockholders and sometimes bond holders take the loss, and the bankrupt organization quietly disappears. If an insurance company goes bankrupt, all of the surviving insurance companies are assessed through the guarantee associations to make the policyholders of the bankrupt company whole. This socialization of losses from bankrupt operations blunts the main force of free enterprise. Through our current system of guarantee associations, we all pay for the mistakes of others. If there is no penalty for mistakes, why shouldn't a company take big risks and let the rest of the industry clean up the mess if it goes bankrupt?

The number three reason for our profitability problem stems from a sort of panic in the field force. This is not a major problem, but it does create a noisy background which detracts us from concentrating on some of the really difficult problems that we have to solve. I have noticed a lot of misinformation coming from the field force which is disturbing. It often creates an overreaction to the situation at hand. I think it has led to the atmosphere which makes us all think that we must credit more than we can afford to pay on Universal Life if we are going to sell any of this product. The commotion in the field force also often leads to an emotional response instead of a rational one. If we are going to make it through these battles, we are going to have to work together with our field force. If we are battling them as well as our competitors, we will have a war on two fronts that will surely lead to a losing proposition.

I will now list just a few things that I think might happen in the future. What is really important is what you think will happen in the future and how you will respond to all of this change. Basically, we have two choices: to

learn to accept the things that we cannot change and to learn how to change the things that we are able to change.

First, I think there will be fewer insurance companies and fewer agents in the future. These trends are already under way. Maybe, there aren't fewer companies, but there are fewer families or centers of insurance. Through merger and acquisition, we will have a fewer number of competitors in the 1990s. I think there will be fewer agents as well because they just won't be able to make as much money as they have in the past. The trend is definitely in favor of lower and more level commissions, and if rebating ever takes hold, there will be significant changes in agents' compensation. All of the indications seem to lead to fewer agents in the future.

Second, I would like to see a shift of insurance coverage from the public sector to the private sector. Politically, I don't know how to get this done, but I think we should try anyway. Maybe, it's pipe dream, but I think we should begin lobbying now to have the Social Security system reduce its survivor and disability income benefits. Obviously, there is no way to even touch the retirement benefits, but I think we could trim the other benefits without much public outcry. Probably, most people are not even aware of how significant these benefits are.

The insurance industry has the capacity to accept a shift of risk from the Social Security system and at bargain rates. There is plenty of room to reduce the Social Security benefits and still maintain a floor of protection to cover those people who would not qualify for individual insurance. I think the ACLI should make this issue a top priority. It would take several years to wrestle any benefits away from the Social Security system, but if we were successful, significant new markets would open up for the insurance industry.

Third, I think that companies that rate insurance companies will play a major role in the future. I believe this because there will be a great need for independent appraisals of companies to tell us which ones are accepting risks in a prudent manner and which ones are accepting inappropriate risks. This could even help with the guarantee association problem. For instance, companies would have to have a minimum rating in order to qualify for protection

from the association. The A+ rating from Best's is still important, but this organization has lost some of its credibility recently when A+ companies have become insolvent. I suspect that companies like Standard and Poors and Moody's will exert more influence in the future because their examinations of companies are more in depth.

Finally, I think that our industry will make a more complete shift to the investment product environment. I wish this were not the case. I would hope that we could go back to selling life insurance as unique coverage. However, I think the momentum is strongly in favor of selling more investment products to the exclusion of life insurance. Along with this, we must accept the realization that our industry will move toward an investment environment which means more regulation and loss of tax favorable status.

There are probably many other things that we might consider that will happen in the future based on the construct that I have presented. However, let me close with one prediction that I think will *not* come to pass. There are many who think that the valuation actuary can be elevated to a high enough position to resolve the imbalance in the economic forces that I have described. While I think that the valuation actuary will play a major role in the future, he cannot single-handedly whip the system into shape. He could not possibly cope with all of the factors necessary to make a rational market out of an irrational one. We, as actuaries, just don't have the power to enforce drastic actions in the marketplace. Our only weapon is financial forecasting which is somewhat dubious when the economic factors that make up our assumptions are so impossible to predict in this unstable environment.

The valuation actuary will, however, make significant contributions to being part of the solution. We, actuaries, are the only ones who are really equipped to analyze and quantify insurance risk. From that position, we will evolve to learning new ways to manage and control risk. This role of risk analyst and risk manager will be very important in the future and presents great opportunities for all actuaries.

If you will allow me, I would like to leave one bit of advice based on the lessons I have learned in this process. The advice is to stick by your

convictions and common sense even in times when the world appears to be going crazy around you. Oftentimes, we rationalize away our problems with unrealistic assumptions in our pricing and valuation instead of confronting the problems head-on as our instincts would tell us. A better thing to do is to confront the problems head-on and be true to the basic principles of our profession. I am quoting an old friend who is quarterback of a football team. He said, "If you are good to your game plan, your game plan will be good to you."

MR. RICHARD S. ROBERTSON: It is easy to agree that it is difficult to price life insurance products profitably in the current market. The market for term insurance has been in a mess for several years, and it appears that the market for interest-sensitive products is becoming increasingly competitive.

There is a tendency to misinterpret the cause of the problem. It is not the result of sloppy actuarial work. It is not even the result of undue optimism on the part of actuaries. And, it is not the unwillingness of company managements to listen to their actuaries in developing pricing strategies. The problem is that company managements have no attractive alternatives.

As Steve suggests, the basic problem is overcapacity. There are too many life insurance companies. There are more agents out soliciting business than the market will support. And, there is more financial capacity to support the writing of life insurance than there is life insurance to be written. Under the circumstances, the law of supply and demand says we are going to get low prices.

The law of supply and demand further prescribes that when prices are inadequate, supply will shrink. And, that is happening. The amount of capital being committed to the life insurance business is not growing as rapidly as the demand for life insurance. The capital committed to the business may even be decreasing. This is happening in several ways. Most large life insurance companies are redeploying capital outside of the life insurance industry -- into property-casualty companies, securities brokerage firms, and other businesses, both financial and non-financial. Companies are also deploying capital away from life insurance within the company -- for example, into group

insurance or pensions. Many stock companies are now pursuing aggressive shareholder dividend policies. Even absent these programs, low earnings itself will tend to limit the accumulation of capital within the business.

There has been a fair amount of merger and acquisition activity within the life insurance business. Not only does this reduce the number of life insurance companies in the market, but when a relatively high price is paid for a life insurance company, the excess of the amount paid over the book value of the company almost always represents capital that one way or another is going to be taken out of the life insurance company, if not immediately, over time.

How does this reduced capacity translate to higher prices? It does so in several ways. As a company's financial resources to write new business become limited, it becomes necessary to control volume. This can be accomplished through pricing or commission control. Or, companies may quit building agency organizations and prune away the less productive parts of their existing organizations. It is no coincidence that companies that have been actively acquiring life insurers at attractive prices typically substantially reduce the marketing efforts of those companies after the acquisition. In other cases, companies may be redirecting capital to those segments of the market that do allow attractive returns. Later, Wayne Bidelman will discuss how reinsurers are reducing their willingness to write reinsurance at inadequate prices.

The problem is not that capitalism is not working. It is working very well. It just takes a while to get where we are going.

One reason that it takes capitalism a long time to effect the corrective pricing necessary is that we have a bit of a structural problem. A significant part of our business is controlled by a very uncapitalistic type of organization: the mutual life insurance company. These institutions are not subject to the same kind of profit discipline and accountability as stock companies. Consequently, they are very slow to take the necessarily painful steps to rectify the situation. And, it is extraordinarily difficult for them to reduce their numbers through the merger and acquisition route stock companies have been following. True, there is a mutual company merger now and then, and there is even an occasional demutualization that takes place. But, at the current

pace, the half life of a mutual company is something on the order of 300 years, so it will take quite a while to get the numbers down to the appropriate level.

Nevertheless, if mutual companies are not profitable, they cannot grow. True, they can, and have been, increasing leveraging to some extent, but this can only go so far. Moreover, many mutual companies are redeploying capital outside the life insurance business, perhaps even more aggressively than stock companies.

So, this describes a pretty hostile environment, at least until the situation rights itself. Capitalism may be working, but it is no fun to be on the receiving end of this kind of treatment. What does the poor actuary do under the circumstances? If the number of companies is to be significantly reduced, how can the actuary help his company be one of the survivors, and not one of the casualties? The answer is that he or she must be smarter, more flexible, and more creative than the average company actuary.

Here are three principles I recommend that you consider.

1. "Anybody can sell the cheapest product." Marketing people don't like to be told this, but if a company has the lowest priced product on the market, it doesn't need highly-paid marketing people, expensive service, etc. The job of marketing people is to get the product sold when you don't have the lowest costs. They need to find ways to add value to the product that is being sold. From a corporate perspective, there is no future in "copycat" strategies, where one takes somebody else's product and tries to beat it on price. There is always somebody else out there who is willing to take you one step further. Companies need ways to add value to their products that cannot be easily copied by others. They need to look for areas where sustainable advantages are possible.

2. "To have the lowest price, one must have the lowest cost." In most markets, it is critically important to be a low-cost producer. Companies must focus on productivity. Sales organizations as well as home offices must become more productive. Low-cost companies have many options. They can use their cost advantages to reduce the price; they can expand

marketing and service; or they can simply bank the excess profit. High-cost companies have no options, other than to cut costs.

3. "Don't throw good money after bad." If you cannot find a strategy to enable you to make an adequate profit in a market, don't keep throwing money at it. Develop strategies to reduce the capital committed to the business. Limit acquisition costs. Focus on becoming more productive. Redeploy your capital into other areas, or take it out through aggressive stockholder dividend programs.

It can be done. There are companies that are doing very well in this environment. Mine is one of them, and there are many others. But, you need a strategy to get there. You won't get there by standing still.

MR. WAYNE D. BIDELMAN: I give Lynn Peabody, our panel moderator, a great deal of credit for at least recognizing that the reinsurer or the reinsurance marketplace must be a part of any presentation having to do with insurance product pricing. It's my pleasure to represent the reinsurer as we continue to explore the current insurance pricing dilemma.

Depending on the type and size of companies that each of you represent, you will have varying degrees of interest in the reinsurer's perspective. The reinsurance marketplace, although distinct, does have an influence on the direct insurance marketplace. I will attempt to review briefly a chronology of significant events that I feel define the historical reinsurance perspective, discuss what I feel the current reinsurer pricing and marketing philosophies are, and then conclude by describing some of the unique pricing problems that a reinsurer has.

Although we all know what reinsurance means, let me highlight some particular aspects for the purpose of my discussion. First of all, I will be discussing only what I call "traditional" reinsurance. In other words, when I refer to reinsurance, I will be referring to the transaction wherein the primary objective is the transfer of one or all of the four basic insurance pricing risks (i.e., mortality, lapse, investment, or expense). This is as opposed to any

attempt to discuss financial reinsurance, where the primary motivation of the reinsurance is surplus relief, earnings relief, or some tax planning objective.

I also tend to believe that reinsurance should be looked at as the wholesale marketplace behind the retail direct insurance marketplace. I also tend to look at reinsurance as a reflection of the direct insurance marketplace; as I will discuss later, there may be good arguments for saying that the direct marketplace is more a reflection of the reinsurance marketplace. However, I think that as an end result the reinsurance marketplace is more influenced by the direct.

I subscribe to the theory that you can't tell where you're going unless you know where you are and where you've been. There have been several times over the last few years when it was necessary for me to describe the reinsurance marketplace in an historical sense. I think the history can serve as a good background for seeing the development of reinsurance pricing problems and can also serve as a reference point for the problems still existing today.

When thinking about the history of the reinsurance marketplace, I was somewhat astounded to conclude that virtually all significant change in the reinsurance marketplace has occurred within the last 10 to 15 years. In that regard, I would like to describe the reinsurance marketplace as having fallen within four distinct eras. I have labeled these four eras as follows: the Prehistoric Era, the Transitional Era, the Revolutionary Era, and the Fallout Era. I will briefly go through some of the elements that made up each of these eras, but I warn you in advance that these elements are extremely oversimplified. Nevertheless, I think a brief review can be instructive.

THE PREHISTORIC ERA (PRE-1975)

During this era, *everyone* was making money. In other words, the direct insurance products had much more margin and were much more profitable than they are today. Therefore, there was considerably more margin with which the reinsurer could work. The direct writing company was not so much concerned with the costs of reinsurance as it was with what the reinsurer could provide along with the cost of reinsurance. Reinsurance at that time was basically a "high cost,"

high service oriented activity. The reinsurance decision was almost strictly the underwriter's, since the underwriting service of the reinsurer was more important than the level of reinsurance cost. During this era, there were just a few dominant reinsurers. "Wining and dining" and hospitality suites were the primary marketing games at this time.

THE TRANSITIONAL ERA (1975-1978)

During this period of time, there was a "low price" reinsurance marketing niche that was starting to develop. In other words, there were some reinsurers who felt they might not be able to compete as a "full service" reinsurer and therefore chose to sell reinsurance based primarily on cost; it was felt that the medium to larger size companies might be interested in low price reinsurance rather than paying for services they really did not need. During this time, there were also many new entrants to the reinsurance marketplace, many of foreign origin. These new entrants needed to figure out an inroad to the marketplace and thus typically chose either the aggressive facultative quote approach or the extremely low price quote approach (or both). It was slowly becoming a buyer's market. Direct writing companies were slowly starting to look to more than one reinsurer to solve their reinsurance needs. After all, some reinsurers were providing both price and service, so the buyer was starting to have the best of both worlds. The reinsurance decision was slowly becoming partly that of the actuaries, due to the fact that low price reinsurance was becoming an obvious source of profit (or lack of cost).

THE REVOLUTIONARY ERA (1978-1983)

As a result of what was described during the Transitional Era, the major reinsurers were "forced" into significant competition. The "niche" reinsurers and new entrants were starting to eat into the major reinsurers' share of the market, and at that time it was felt that retaining a significant portion of the marketplace was very important to profitability long term. Unfortunately, high inflation and high interest rates were forcing the direct marketplace to term versus permanent products. There is little in the term product with which to compete, other than the absolute level of the premium. The actuary was now involved in the reinsurance decision by necessity, since he had to figure out

any way possible to keep his direct product premium rates below that of his competitors. This Revolutionary Era proved to be the peak of the aggressive underwriting and pricing by the reinsurers.

THE FALLOUT ERA (1983-?)

Due to the activity during the Revolutionary Era, reinsurers started experiencing significant losses. Suddenly major reinsurers were starting to withdraw from existing arrangements and were no longer quoting on some term products. Facultative quote procedures were severely tightened by reinsurers. Many reinsurers required that some retention be kept, charged a high first year fee, and/or took facultative business only from automatic clients. Many of the major reinsurers started implementing significant and drastic cost-saving procedures, including reductions in staff and the realignment of sales and service offices.

We are still in this Fallout Era, and it is far from over. Steve Radcliffe and Dick Robertson discussed the over-capacity situation in the direct marketplace. Indeed, the potential population of reinsurance clients is every bit as small in comparison with the number of reinsurers as the number of potential clients in the direct marketplace is to the number of insurance providers.

Will there be a return to the Prehistoric Era? In general, I find this highly unlikely. When I say unlikely, I am basically referring to the high profit position we found ourselves in on both the direct and the reinsurance side. Those kinds of margins will likely, and unfortunately, never again appear in our products. The cost of reinsurance will forever more be a significant consideration in the reinsurance decision. We may well see, however, that we will get back to a smaller number of reinsurers. As long as the direct products remain so competitive, the reinsurer's profit must likewise be thin.

The question might become, "Who is at fault for the current situation?" One could well waste his time trying to answer this question. If there is any blame to be laid for the results of the Revolutionary Era, it must fall on both the direct writing companies and the reinsurers. There is no question but that the reinsurers became much too aggressive in their pricing and underwriting

approaches, and likewise that they allowed direct companies to get away with poor product pricing and poor design by supporting them on the reinsurance side. As Steve Radcliffe said, you can't expect the valuation actuaries to be able to change the entire direction of the marketplace by themselves. Likewise the total blame cannot be placed on the reinsurer for not putting a stop to some of the types of things that were allowed to go on in the direct insurance marketplace. Therefore, I think any "blame" can be spread.

Is reinsurance a reflection of the direct marketplace or the other way around? Despite occurrences during the Revolutionary Era that raises this question, I still feel reinsurance reflects direct. The Reinsurance marketplace may expedite the direct marketplace, but it still is in response to requests made of it.

One conclusion that must be reached as part of the Fallout Era is that smaller companies must beware. It is the smaller company that needs the most assistance from a reinsurer. As I will be discussing here shortly, the reinsurers will do everything in their power to become much more cost effective and will likely need to do a better job of charging for what they truly provide. Theoretically, this means the smaller company must pay more for its reinsurance. The small company is trying to compete in a marketplace that, as we have discussed, has over-capacity and where the driving competitive force is the absolute price level; comparatively higher reinsurance costs and pressure for a lower direct product price is a potentially fatal squeeze for the small insurance company.

Let me briefly describe what I feel are the key points with respect to the current reinsurer pricing and marketing philosophy. First of all, as best as anyone can tell, virtually all of the reinsurers are after profit, not market-share at this point in time. There are many different tactics that each reinsurer is using to stay viable. One specific approach is to provide specific and special ancillary services. In other words, in addition to trying to provide the reinsurance product at a competitive price, many reinsurers are trying to help you by providing direct products (either in the life or health side), laboratory services, software packages, and the like.

I truly believe that most reinsurers are trying to build long term relationships in their client base. This is partly for selfish reasons. A reinsurer has to go to an immense amount of effort to do an adequate job of quoting on a product. Unlike the consultants in this business, the reinsurer does not get paid except by receiving the account and making money on it. Therefore, the reinsurer wants to keep the client long term.

When you come right down to it, the reinsurer must match the ceding company's pricing and marketing philosophy. In other words, if the client company is going for a super-select underwriting category of insurance, the reinsurer cannot come in with a standard generic quote that might assume both normal nonmedical and medically underwritten business. Likewise, the reinsurer must understand and support the fact that the company might be in the brokerage business or in the direct response business and be willing and ready to support the client in that endeavor, either in its pricing or in the necessary service aspects.

An additional strategy for every reinsurer is to minimize the extreme financial exposure. The best example of this is to try to eliminate, as much as possible, the high first year allowances that became customary during the Revolutionary Era. The reinsurer is also looking much more closely at who the client is and what its financial strength truly is. Regulators are not easy on reinsurers when financial trouble befalls the ceding company.

At the risk of being cliche, the following two quotes also pretty much summarize the current situation: "You get what you pay for," and "Everyone has to make a buck." Finally, one must recognize that if there truly is a "squeezing" of the retail prices, one can expect nothing but a continual squeezing of the wholesale (i.e., reinsurance) prices. Unfortunately, unlike the marketplace for other commodities, the retail (direct) prices actually set the limit for the wholesale (reinsurance) prices. In general, most reinsurers must be questioning (at least behind the scenes) whether the traditional reinsurance marketplace provides an adequate return for risks taken.

I mentioned earlier that a reinsurer truly likes to have a long term client, primarily because of the immense amount of work that goes into every quotation

that is made. I would like to briefly outline some other unique problems that the reinsurer has, which I feel are important for the direct pricing actuaries to understand. First of all, the reinsurer now finds himself in an almost pure term marketplace. In other words, virtually all the traditional reinsurance that a reinsurer writes these days is either yearly renewable term or monthly renewable term, or it is coinsurance of term products. There is very little pure coinsurance or modified coinsurance of permanent products. What this means in a marketplace with already squeezed prices is that the reinsurer is on the mortality risk almost exclusively, with a very low margin for error. Steve Radcliffe mentioned the low margin for error in his annuity product analogy. If any of you have done sensitivity studies on differing mortality scenarios dealing with a very low margin term product, you can begin to understand the position that the reinsurer is in. The reinsurer has no opportunity to make any additional profit in the spread on interest rates (for example).

Let's face it -- the reinsurer must analyze the results of every creative pricing actuary in existence. This forces the reinsurance actuary to be every bit as creative, yet be competitive and still make a profit for the reinsurer. Likewise, the reinsurance actuary must analyze just about every existing type of marketplace and pricing contingency. Except for the extremely large direct writing companies, any new ideas or creations of marketplace or products must be run by a reinsurer or many reinsurers somewhere along the line.

A reinsurer is also under some rather unusual "persistency" situations. We all understand what a lapse, surrender, or death claim is. In addition, the reinsurer has several other "lapse" contingencies. Have any of you tried to guess at the progression of the net amount at risk on a universal life product, such that you can determine a reasonable reinsurance rate for that net amount at risk? Whatever assumption is made must be put on top of the already existing lapse assumption at the policyholder level. The reinsurer must also allow for the contingency of recapture at some point in time. Even though it may not be possible unless the ceding company changes its retention, the reinsurer must still make some assumption as to what will occur at that point in time.

We could talk all day about the inherent problems in the policy change areas. Much has been discussed about the risks to the reinsurer of the effect of

internal and external exchange programs. Any reinsured policy change that calls for anything other than a continuation of the already anticipated reinsurance premiums causes a persistency contingency for which the reinsurer must price.

Finally, the reinsurer is exposed to a very significant risk that I would like to call "nondisclosure by the client." I am referring to both an intentional and an unintentional nondisclosure of pertinent information by the client. It is hard to believe that there would ever be an intentional nondisclosure, but it does happen.

The purpose for outlining what I consider to be some unique pricing problems for the reinsurer is to make a case for what I would call "active cooperation." Many clients say that they are highly cooperative with their reinsurer, and that they always welcome answering questions and discussing things. By active cooperation, I mean that the client should anticipate the needs of the reinsurer and try to help him with his job. It is the direct writing company that has come up with the creative ideas: the new underwriting classifications, and the new "bells and whistles" on products. Give the reinsurer a break and at least share with him what assumptions were used in the product, or at least give the reinsurer the benefit of the thought you've already gone through. Can you guess the number of times someone has come up with a totally unique product (including underwriting approaches) that he may have spent years developing and researching, and then with only a half page letter send it out for a reinsurance quote to 20 different reinsurers? The situation could well be that the most aggressive bidder is likely the one that understood things the least. This is not the beginning of a long term relationship; it is an example of what went on in the Revolutionary Era and of what is still going on. If the direct writing companies and the reinsurers had worked together on determining what in fact truly made sense for both parties, we might not have forced the current dilemma in at least this part of the insurance marketplace.

My final note is that we reinsurers would like to develop an atmosphere of active cooperation from our direct insurance company clients and prospects. Both marketplaces have serious pricing problems, but let us not aggravate them by playing games with each other. Let's work together to help resolve them.

A DISCUSSION OF CURRENT PRICING PHILOSOPHY

MR. PEABODY: There was a very common thread running through all of those presentations, it seemed to me, and it was very interesting as I saw it developing as we were putting this thing together. When I first asked Dick Robertson to be on the panel, he sent me a little note. The topic at that time was strictly "What Have We Done to Ourselves?", and I think Dick's comment was a very good one. He said, "We haven't done it to ourselves. I'm not sure that we as actuaries really price products. I think probably as actuaries, we have the responsibility of providing information to management about the results of the products that are being sold. But as far as putting the actual numbers on the products, I'm not sure that we really do that." I think in each of their presentations, there was a very common thread that our pricing philosophy today is not one of just putting down numbers, working with assumptions, working with methodology, but is much more importantly, one of trying to understand what's going on around us and what the implications are of that marketplace that surrounds us. Not only in the direct marketing area or the direct business area but also in reinsurance.

MR. WALTER N. MILLER: I would like to congratulate the panel for being very much more credible than most of the illustrations we see these days. And that's what I'd like to talk about a little. I think it's important for us all to realize that when we talk about pricing in a context like this, it really is being used in a very different sense from what is typical of pricing in almost every other segment of business and industry. After all, if you buy a car or a box of cornflakes or the services of a stockbroker in buying or selling a financial instrument, in the overwhelming majority of situations, as far as price is concerned, what you see is what you get. The price is the price. You pay it and that's it. In the individual life insurance business, I think that statement has been true only with respect to guaranteed cost fixed premium nonpar coverages which are pretty much a thing of the past.

We are not really in the pricing business. We're in the business of constructing illustrations. And then maybe some of us are in the business of constructing some game plans as to what may happen to our companies in the event that certain sorts of economic and other scenarios are run against those illustrations. But we are constructors of illustrations, and we are seeing some very interesting things with respect to all of the elements of these,

illustrations of products with non-guaranteed pricing elements. Steve mentioned one where we see at least some evidence of some illustrations that are being produced at, let's say, an illustrated 11% rate, the presumed purpose of which is to attract new dollars that the company can take a little bit of and pay to the agent and pay some administrative expenses and then turn around and invest the balance at 9%. Now maybe there is some synergistic effect there that makes everything good, but I haven't found it yet.

We see illustrations that implicitly have built into them the assumption that mortality charges associated with the product are going to reduce at specified levels far into the future, which carries with it the other interesting implicit assumption that, if improvements in mortality experience of that magnitude actually do occur, the issuing company is going to change its name to the Magnanimous Life and pay every nickel's worth of those improvements back to the policyowner.

We see some illustrations based on the assumption that unit expenses, embarrassingly high now, through programs, some of which are on the drawing board and some of which aren't, are going to reduce to levels in the future that justify the basis of the current illustration. We are constructors of illustrations.

Dick, I'd like to reassure you. I think there are two significant forces at work that are acting very strongly to reduce the 300 year half life of mutual companies. One of those forces is the portions of the 1984 tax law that are in there at the instigation of the stock companies. The other of these forces are the activities of the mutual companies themselves. Because, of course, we mutuals are just as active in constructing illustrations for products with non-guaranteed pricing elements. We don't just issue traditional par anymore. If some of the reports you hear have a shred of truth to them, even traditional par with its supposed concepts of equity, etc., no longer prevents some of the actions that have been indulged in by both mutuals and stocks in constructing illustrations.

I would appreciate some comment from the panel back to us as professional actuaries. In our world as illustration constructors, what's our

responsibility? What's our company's responsibility to the public? What's our responsibility as professional actuaries to our companies and our public?

MR. ROBERTSON: I guess I'm getting well off my field now because I don't think I've ever prepared a dividend illustration. But I can certainly understand the problem. I don't know how we can get ourselves in a situation where we are making inadequate profits on a basis where we don't even disclose what the price is. But that seems to be happening, and there is something that isn't adding up here properly. I mean if we can get away with selling a product without telling the customer what he's paying for it, we ought to be able to coin money. But it doesn't work that way. And I haven't really sorted out what is wrong here. It may be that this area of trying to figure out how the cost is measured is going to be something that is going to have to receive attention both within and outside of the business. But I guess I can't see how that could make it any worse. It can't be worse than it is now. Incidentally, with respect to the taxes, I guess I want to point out that the stock companies didn't design the mutuals tax law. All we wanted to do was to be sure that the mutuals paid their fair share and the mutuals created the way they do it. I don't think the stock companies would have had the gall to design that system and try to foist it off on the mutuals though.

MR. RADCLIFFE: I'd like to make an observation. I just finished taking the Series 7 National Association of Securities Dealers exam. In it, the 1933 Act is called the Full Disclosure Act. The reason that it became law was that people selling investments were not making full disclosure in the late 1920s, which in part led to the stock market crash. I see our insurance industry heading down the same path. We are not giving full disclosure of our products, and possibly the same thing could happen to us that happened to the investment industry. We could have a lot more regulation on what we illustrate for our prospective buyers. It's incumbent upon us to make full disclosure. This is a cousin to the valuation actuary problem, that the pricing actuaries should take all of this on their shoulders. I think many pricing actuaries are trying to maybe not be as flagrant as the other guy in making illustrations, but we are all probably bending the rules a little just to stay in the ball game. By the way, the only reason that we are not regulated by the 1933 Act is an exemptive clause. We are not that far away from being regulated by the 1933 Act. All

you have to do is remove that clause, and we're regulated. Politically we're a long way away from it because it would be very difficult to remove that clause.

MR. ROBERTSON: But, Steve, the worst abuses and illustrations in the marketplace today are on fixed dollar mutual funds that are subject to the 1933 Act. There is all kinds of garbage out there. Capital gains and current returns are being mixed and advertised as a current return. You can buy a 12% mutual fund these days, and it is earning it. Mutual funds are earning it by selling off their old high coupon bonds, taking capital gains and paying it out to their customers. So they all found a solution. These companies are doing stuff we never dreamed of doing.

MR. MILLER: One more comment, if I may. I agree, Dick, the solution isn't here. I guess I'm a bit worried about our profession in that I don't believe we have gone far enough in even admitting there is a problem. And I hope we do a lot more of that. I hope we start working actively toward solving our part of the problem. Obviously the situation is not totally of our making. It shouldn't come down totally on our shoulders. But we really do count. We know more about the forces that are involved than any other set of people or discipline that is involved. I hope we can agree that there is something that has to do with the professional identity of the actuary that is going to help us do more than we have in the past to constructively move these things forward. The way things seem to be going, I would venture that within perhaps just two or three years, there are going to be some addendums or some new questions in the annual statement relating to pricing of all sorts of policies with non-guaranteed pricing elements, traditional par, the new breed of policies alike, where an actuary is asked to comment on questions like: If current experience continues, do you think your current "pricing scale" can be continued? The way that we respond to answering those questions is going to have a lot to do with the course of events and with our own identity and worth as a profession.

MR. DAVID B. ATKINSON: I'm a pricing actuary among other things, and when I price a product, I feel a little marketing pressure to be competitive. And to tell you the truth, the way we price products, we can't cover all of the expenses of marketing right now. We have to assume we're several times bigger

than we currently are. And I'm more than willing to back off that if some of you guys would do it with me. But as it is right now, my hands are pretty much tied. If I was as conservative as I'd love to be, we wouldn't sell another product. And I imagine there are a few other companies in the same ball game.

MR. PAUL H. LEFEVRE: I'm starting to see a little bit of is what I'll call the nonbelievers. There comes a point, I think, in these pricing wars, when one of the publics (either the agents or the public itself) starts to realize how thinly priced the products are and they ask the old bait and switch questions. And I think that that is one element that is probably going to start hitting us soon when people start saying, "You guys can't do this. You are illustrating this and next year you are going to drop the rate." Or "Next year you are going to charge the charge in your policy that you are waiving this year." And I think that once you start doing that, that is when you are going to start seeing the backlash.

MR. ROBERTSON: Think of a small company pricing a product, and the only way that company can compete is to assume a level of expense significantly lower than that company is currently experiencing. Something is going to have to happen.

You are either going to need a game plan to get to that level of expense very fast, or you are going to have a level or profitability that is going to create some pressures that will get you to be part of a company that is big enough to have those expenses. It is perhaps a good example of the kind of thing that has to change. It is not a stable situation.

MR. RADCLIFFE: I sense a state of shock and depression and concern about the future. We are going to have a lot of change, and we are going to have to deal with that change. We will have to learn to live with some things and learn to try to adjust other things that we can control. I would like to get back to the point that I made about trying to get more of a marketplace in which to sell life insurance. I think our move to investment products has to a large extent forfeited a basic right that is unique to our industry. We are the only ones that can sell life insurance. The investment guys can't sell life insurance unless they buy a life insurance company. I think we ought to

refocus on that unique right of ours and try to get back to the business of selling life insurance. I illustrated how it's very difficult to do that these days, but with some help, we can increase that market share. I don't believe you can go back to the good old days of selling life insurance, but we should go back to those basic principles and adjust them to our current marketplace so that we can recapture our unique right to sell life insurance policies. I see a thread of hope in all of this and that if we start working on those kinds of solutions that we'll have more success in the future.

MR. MARC G. VERRIER: I think before we start to worry too much about what we as actuaries are doing as creators of illustrations, although it is a substantial part of the pricing actuary's job, it's worth remembering that the pricing action in reality stands between two parties. On the one side is the agent and ultimately the policyholder who review the equality and competitiveness of his product. On the other side, the pricing actuary has to deal with his insurance company management whether he is part of their group or not. It doesn't really matter. But he presents that product as being profitable to a certain extent or not. Down the road, he is either going to meet the requirements of both of those constituencies, the agent and the policyholder on the one side, and that of management, or there are going to be problems. If ultimately the company does not deliver according to expectations of the policyholder, then other companies will use that against the company and the company will suffer. If the company doesn't deliver profitability, then it will be paying there as well. So I think we need not worry too much about the issue. I do believe the market ultimately will sort it out.

MR. RODNEY C. WILTON: I think part of the problem that you are talking about in pricing and in illustrations is that the illustrations don't mean anything. Many companies are now illustrating dividend scales that are based on portfolio rates. They are well above new money rates. And they know that they are going to have to drop their dividend scale within the next year or two. But they are still illustrating those. And perhaps the agents are even telling people that for the last 25 years, because of the good judgment of the company, the company has always paid at least the dividends shown in the illustration scales. No mention is made at all about increasing interest rates. And then down at the bottom of the illustrations will be a disclaimer

saying these are neither a guaranteed nor a projection of future results, which the agent probably passes off as, "All these illustrations have that and we just have to put it in. The law says." And you have the similar thing on the non-par side in universal life consumer products where you are talking about paying 10 1/2%. Currently the company can afford to do that. There are no reserves or any cash in the thing to pay it on anyway for the first year or two. But in all of these illustrations, nobody has attacked the question of what is promised. And I think that the public out there, the purchasing public, should have a right to feel that when they get an illustration which indicates that under current conditions of mortality, expense, class interest rates, etc., if they continue, that this is what will happen.

In the industry, I think many of us feel uncomfortable with what is being done. It has been mentioned about competitive pressures forcing us to do it. And what has happened in other industries when you get competitive pressures and companies are unwilling to clean up their act is that the government steps in. And that will happen. Or else another thing that can happen is on occasion consumers can step in or you can get a rating agency, Ralph Naderism type of thing. But I feel very uncomfortable myself with what we are purporting to show to the public, when in our own minds perhaps we know that we are giving a false impression.

MR. ROBERTSON: Rodney, you articulated what is really bothering you about illustrations. Everybody in this room knows that dividend illustrations have very little credibility in terms of the long-term. We know they are not intended to be for the long term. I'm not sure you'd agree exactly what they are, but I think we can agree on what they are not. Basically when you are selling a life insurance product in public, you are really saying, "Trust me. We are going to give you a fair share of the profits on this product." And I think by and large the industry has kept that promise. There have been a few exceptions that have abused it, but you look at the great bulk of participating insurance sold, and companies strive mightily to do a fair job of treating their policyholders properly. I always felt that one of the strengths of the new types of products that are available is that they give the customer a better understanding of exactly what is going on with this product. Now this is very much a philosophical position.

Compare, for example, a traditional par product without direct recognition of interest and universal life. With the universal life product, we are told we are going to charge you mortality at this rate, we are going to take off expenses at this rate, and we are going to credit an interest here. Now in the product development process, a choice had to be made at some point. Are we going to give ourselves the flexibility to change any or all of these elements or are we going to guarantee them? We, at least initially, said we are not sure what the marketplace wants.

To the extent we guarantee these rates, we have to construct our ability to manage them so as to live within the guarantees. We can give an indexed policy, for example. Then we are restricting this to our investment philosophy to something that will support the index. We can guarantee mortality, but then we have to put margins in our mortality that will compensate us for the risk of not being able to experience that mortality.

We market tested various combinations of those things. The public still is willing to trust us. It will continue to trust us as long as it thinks we will treat it fairly. I am not uncomfortable with that approach, even though it does leave itself open to substantial abuses. I cannot imagine a buyer of life insurance really believing he is going to get 10 1/2% on that policy if market conditions stay the same as they are. Buyers are not that dumb.

MR. WILTON: Well, I went back to the record of the 1930s and the last time the dividend rates were cut. There was a lot of discussion about how people felt about this, how people felt about illustrating 20 years of dividends. And some companies cut back to just illustrating one year of dividends. But there is some difference between saying, "Here is a par policy. You have a level guaranteed premium. We are going to give you dividends on it. Here is an illustrated accumulation of dividends or an illustrated accumulated paid up additions." There is a difference between that and illustrating an enhanced life, where all the customer is told is he has a low guaranteed premium, and with the dividends, he'll get $250,000 of insurance. His base amount of insurance is $50,000. But he has no feeling for why that happens or what will happen when dividend rates aren't as high as in the illustration. So when dividends are used under an accumulation, sure the buyer has a feeling if

dividends are higher, he gets more; if dividends are lower, he gets less. Under universal life or under enhanced life on the par side, he doesn't have that ability. So I think the products are not as transparent as they used to be. Although in universal life they are unbundled to an extent, but it still isn't as transparent as an old par policy.

MR. ROBERTSON: One other thing I meant to mention on modern products is agents selling universal life now know something that agents selling participating insurance don't know. That is that dividends can and will be cut. I think any agent that sold a policy with a 12% illustration and in some way implied there is a guarantee is in trouble with his customer right now. And I think that if the agents didn't know that at the starting point, they are learning it now. They are learning that they have to tell their customers what that interest rate really means. I think most agents are doing that now, certainly those that have been in the new generation product for any length of time.

MR. RADCLIFFE: I want to mention one other positive thing. Mr. Tobias's graph, I showed two million people in the industry. Mr. Tobias thought that it should shrink to a million, but he did not think that the sector for actuaries should shrink. I think it's rather amazing that we have had as much influence in our industry as we have had. I think we should be congratulated for that because that little tiny segment has had a tremendous impact on this industry when you look at it from that perspective. Dick Schweiker in the General Session said the public trusts actuaries, and we have developed that trust by doing a lot of things right, and we're continuing to do things right. In the future, we're going to have a lot more influence. Right now we're a little unsettled because we don't have as much influence as we would like. With the valuation actuary's contribution, we're going to have a lot more influence and control. The time is not right now, but the time will be right later on. We are going to go through an uncomfortable period, but I think that actuaries are going to win out in the end if they maintain their principles through this period.

MR. JAMES F. REISKYTL: Some of us have struggled for some time on the dividend issue and then the non-guaranteed issue. In fact, I'm sure Walt

Miller wasn't asking rhetorical questions, because I think he now serves on the Academy committee. The entire structure has been built on disclosure. As you know, we prohibited nothing. We encouraged everything. In fact, Dick Robertson was one of the people who was quite concerned with our initial developments in the non-guaranteed element, that we were inhibiting product development and creativity. Well I'd say we have a lot of creativity in the marketplace today. And so he was right, that we have not inhibited it in any way. I also take some comfort that the marketplace will eventually sort itself out, but I'm very concerned that it will be to all of our disadvantage when it does figure out what has happened. And so I ask this question which the entire disclosure thing is based on. How many of you are truly disclosing, whether it's a non-guaranteed element or a dividend illustration, what your experience is based on: What would have to happen to pay that dividend or that illustration? Do you know when the investment period begins and ends? Do you even know as a company? At times I wonder. I have heard reports that these definitions vary, and they change from year to year. I don't mean to make this very negative, but we're really going to have to give the public something useful to deal with, if we're going to base our marketing on disclosure. We have questions in the annual statement now that say, "Mr. Actuary, do you believe in the current scale if current experience continues?" How are you answering these questions? I agree wholeheartedly with my stock company friends who say the pricing actuary does not have the proper authority within a stock company and perhaps not within the mutual company, although he may have more in the mutual company. If the decisions are not made by me, the actuary, then don't put all that responsibility on him. But if not the actuary, who? Who will disclose to the field forces and more importantly to the perspective buyer and past buyers? What will have to happen? And what do you think is happening? Do you have a basis for what you are selling?

MR. ROBERTSON: Jim, I think the problem is that for the buyer of a life insurance product to judge his or her cost, you would have to disclose something that you don't have any idea of. You are a low cost company right now, and I would be very surprised if that were to change. I think the thing that is probably most important to a buyer from your company is that this is a company that has always treated its policyholders very well; your costs are currently as low or lower than most or all of your major competitors; and you

are passing on the benefit of those costs to your customers. Furthermore, you are telling them that you believe as a company that you will do your very best to continue that practice. That's what you are providing. But if any of those factors changed, the product that is being bought today would not be as attractive as a product from a company that was operating on a different philosophy. And there is no way you can disclose to your customer that that is going to be the case.

MR. REISKYTL: That's true. But I believe a dividend illustration reflects the current experience of my company and hopefully of any company which is putting out illustrations. If not, I must commend one large eastern mutual which came right out and said, "These dividend illustrations do not reflect our current experience. They reflect expenses that we hope to achieve if sales increase." Now the buyer knows that the illustration being shown to him at the time of purchase does not reflect the experience of the company. I can only assure you that we will do our best. We will reflect whatever emerges. We have no lock on good experience. We guarantee that we will reflect it, but at least the illustration reflects our current experience. And it seems to me that, if a company is not having good experience, that ought to be disclosed to the buyer. And then the buyer may make a choice and say, "This company may have lower costs in the future, but to achieve it, they must do something. Or they may have better mortality in the future, but they are assuming they will not for purpose of illustration. Isn't that an obligation we have? I could tell you, even with our basis, our prospective buyers do not believe our current interest rates in the dividend illustrations. And they are already asking us to provide illustrations with lower rates that they believe will more likely be paid in the future.

MR. ROBERTSON: Jim, aren't you really trying to set the rules of the game to your advantage? You are saying the things that are the most important to describe to the customer are the things that you do well. I admit they have some relevance, but they are not the only relevant things with respect to the cost of the product to that customer. That's the problem.

MR. REISKYTL: But if you don't base it on what you are doing, then what do you base it on? I believe I'd make the same speech if I represented another

company. This is a basis for illustrations that makes sense to me. The world of projections is totally different. I would hasten to add anytime we get into a situation, simply ask the other company what must be done to pay what they are illustrating. I believe that simple question would go a long way if answered, and answered honestly. It would go a long way to straighten out the problems we have in the marketplace today. Sometimes you may not know the answer. And that may be your answer. But to give you another answer, what basis would you propose?

MR. ROBERTSON: Well obviously, I don't have a solution because I am coming in from the position that there is nothing you can disclose that is going to get the job done -- 1933 Act material doesn't do it; illustration of current experience, while of considerable value, doesn't either. But someone else coming from a different perspective could attack your position partly on the grounds that the way the dividend scale is put together and packaged really is a confusing and difficult thing to understand. A direct recognition approach at least explains to the customer how the customer participates in the company's experience, if you are talking about equities between current and past generations of policyholders. What I am trying to say is that depending on where you are coming from, you can come up with some very logical arguments saying this is the best way to do it. And no one answer is right. When you come right down to it, it's the reputation strength of the company that the policyholder is buying. And the smart policyholder buys that and not an illustration. I would speculate that most customers see those illustrations that show your company much better than the six or seven that are chosen to be illustrated as competitors. They say, "Yes that's nice. I wouldn't expect to see those if it wasn't that way. But I know the company, and I trust the company and the agent." That's what you are really selling. And I don't know any other solutions.

MR. REISKYTL: We have built a structure on disclosure. The disclosure for non-guaranteed elements, in my opinion, is a lot weaker. But if it is not effective, we are going to have to replace it with something else. And it's the best thing we have, perhaps because I was part of it, but I also believe it is the way to go, and we should not outlaw anything. And I believe we must work on improving our disclosures.

MR. GREGORY J. CARNEY: Utah, as part of its policy approval requirements, demands that any illustration that is done not use an interest rate that would be greater than the company would credit if there was no change in interest rates in the future. So in other words, if you intended to offer a new money rate today as an attraction to get people in and you then intended to drop it to a lower rate two or three years into the future, in Utah you have to illustrate at that lower rate. I'd like to make a couple of comments about pricing and get back some of the things that Steve and Dick were saying earlier. When I was coming through the exams, I learned how to price the mortality risks. Unfortunately, we are not selling those products anymore. I'm not sure that I have the foggiest idea of how to price the investment risks or to price the options that we are putting into our contracts. We're continuing down that path into more and more investment products, and I think the tax laws are encouraging that too since we are one of the few tax shelters left. I think this is totally going to amplify this pricing problem. I don't know how we get products like modified guaranteed annuity products or the variable products as successful products that they should be when the pricing differential between those products and the fixed products does not make any sense for the consumer to buy it. He has to go with the fixed products and let us take the risk.

MR. ROBERT M. ASTLEY: We've been involved in a discussion of the illustration problem, an arcane discussion that no one outside of our industry would understand or likely have any interest in. But it relates to something that Stephen Radcliffe had to say, and that is the two million people that are involved in our business and the complexity that we have built into our product and all of the aura surrounding illustrations and the lack of consumer understanding of our product. An event happened in Canada three or four years ago that quite literally scared the pants off a great many of us. But it's an illustration of the kind of fundamental business analysis that we as actuaries ought to be doing instead of devoting ourselves solely to looking at current rates. The Bank of Montreal came out with a free option for life insurance for everyone who deposited funds with them on an Registered Retirement Savings Plan program, which is equivalent to the IRA here in the United States. The cost of the life insurance was so trivial that the bank guaranteed to provide the same rate on the investments that any other provider would have, and it would throw in an amount of insurance equal to the amount of the investment. And if we

believe that those fundamentals are going to go away, we are deluding ourselves. We have to go back to the real essence of our business and try to decide how we are going to compete in the future and where the threats are going to come from.