RECORD OF SOCIETY OF ACTUARIES
1987 VOL. 13 NO. 4A

DEBATE: SHOULD MINIMUM NONFORFEITURE VALUES BE REQUIRED BY LAW?

Moderator: PHILIP K. POLKINGHORN
Panelists: PAUL T. BOURDEAU
WALTER N. MILLER
Recorder: DOUGLAS A. FRENCH

Pro: The standard nonforfeiture law is an impediment to product design. Competition is a sufficient safeguard for the public.

Con: Consumers do not understand the intricacies of cash value life insurance. It is the regulator's duty to protect the public and the standard nonforfeiture law is a necessary regulatory tool.

o Part of the session will be devoted to a discussion of desirable changes to the standard nonforfeiture law, with input from the audience.

MR. PHILIP K. POLKINGHORN: Paul T. Bourdeau, who has had 19 years of individual product development experience prior to moving on to senior marketing positions, will be taking the pro side. He is now CEO of Beneficial Standard. Walter N. Miller, Vice President and Actuary, at Prudential will be taking the con side. He is a member of the Society of Actuaries Board of Governors, a member of the Society of Actuaries Education Policy Committee and a member of the Interim Actuarial Standards Board. He is also chairman of the committee that is a task force on nonforfeiture issues. Each panelist will present his or her arguments and will be allotted a very brief moment for rebuttal and further comment. At that point, we would like to get your input and your views. In particular, Mr. Miller's committee would like to keep posted on the profession's attitudes toward this issue.

MR. PAUL T. BOURDEAU: The official title of this presentation is "Should the Minimum Nonforfeitures Values Be Required By Law?" I think a more descriptive or more apt title would be "Strangled With Good Intentions." The quick answer

to whether minimum nonforfeiture values should be required by law is, in my mind, no. In perspective, there are a lot of theories in what happened to the Great Roman Empire. In the book, *Grandeur That Was Rome*, Stobart, the author, concludes that bureaucracy of the Imperial Palace, which governed the Roman world, strangled it with good intentions. Few doubted the good intentions, but strangulation nevertheless occurred. In today's world maybe we can gain some insight from this. I will open the presentation with a few comments on what I consider the key problems and limitations of the regulatory process. I will then discuss some of the problems, inconsistencies, frustrations, inequities, quirks, manipulations, complexities, delays and flexibilities that we have all experienced while working with a nonforfeiture law over the years. I will then highlight why I feel these laws will continue to create even more and bigger problems in the future. Lastly, I will recommend some fundamental change.

Let's talk about the regulatory process. Most of the regulators I have known have been hardworking and dedicated, with a high degree of good intentions. So why does the regulatory process go awry? There are a number of reasons. I think first is the natural tendency for us and the regulators to be very comfortable with the status quo. We are all going to be dragged into the 21st century, I am sure. Insurance companies are no different, but there is one big difference and that is intense market forces. The key in competition just forces change upon us. In fact, I think that's one of the only ways that we really change. Market forces are nonexistent for the regulators. Therefore it is not surprising that they are relatively unresponsive to change. You can't blame this on any person or any group of persons; I think it is just part and parcel of the regulatory process. You can see that although it can be as laden as it wants to be with good intentions, it doesn't have that spur or that extra push to change. There are industries that have changed. Whether it's regulation Q in the banking industry or whether it is the commissions on stockbrokers, it's market forces that change these things. The money market funds, for instance, forced the change on regulation Q. It was certainly not the regulators that said, "Hey fellows, it's time for change."

Let's move on to some of the specific problems created by nonforfeiture values. Especially since the advent of flexible premium in reference to a product, I think the laws have come to the point where they are so contrite and so complicated that they just become a game for a handful of specialists. Our customers, our

marketers have no feel for them. They don't even understand the basics; the little things like the higher the interest rate, the lower the guarantee cash value, confuse everybody. We can't expect them to be very close to the very complex issues. We have in our industry relatively poor data processing for our data processing systems design. I think a lot of that is due to the inability of analysts and programmers, unless they are actuaries, to deal in a real, conceptual way with nonforfeiture principles. We always dream of the great simplified tontine contracts; as long as we have the standard nonforfeiture law they are just a dream. With all the legalities and actuarial mumbo jumbo required by nonforfeiture laws, there will never be attained what we call simplicity.

There is also today an incredible built-in tendency in the law to favor the terminating policyholder to the detriment of the continuing policyholder. We have incredible volatile financial markets keeping competition and pressures on our interest rate spreads. As you talk to regulators today, there is no sense of this pressure. There is nothing more on the mind of regulators today than the financial well-being, or solvency, of the companies. Unfortunately the rigidities of the nonforfeiture laws don't allow the companies to adequately protect themselves from financial disintermediation. That's a very serious flaw, because the law essentially requires cash values at all ages. True matching of assets and liabilities, unless you are going into cash or cash equivalence, is an exercise in futility in our industry. One of the things that has frustrated me most about the standard nonforfeiture laws is the seemingly endless unintended quirks. This is because the law is simply too detailed. Each new generation of the standard nonforfeiture law is heralded. This is the one that will make the changes and eliminate forever all these messy, unintended quirks. But what happens is that you get even more and bigger unintended quirks as product innovation moves on. There has been a constant parade of these unintended quirks. I can go back to the mid-1960s, when you had the term riders with those little bitsy cash values, $4 or $5 a thousand; they were just required at the time. Think of the problems we had before the dynamic interest rates.

Another item that is highlighted when we talk about this is the limitation on innovations presented by the laws. These are pretty well-known, but I have a few comments. I think in Canada the absence of these laws has led to a lot of interesting, timely changes. In the United States, I know from my product development days, we were always coming up with great things for estate

planning and other purposes; but they could never fit into the nonforfeiture model. An example is where you might want to give an attractive paid-up, at 7.5%, but your cash value is at 5.5%, so you can't do that. Another area is situations that weren't contemplated in the law when it was developed.

There is a big argument over what the right nonforfeiture value is. Listen to a few actuaries in a lounge talking, and you'll find it very fascinating. You'll need the present value of this times this, that, and the other thing. However, once you get the cash value, you have to redo it because the present value has changed. What it does is lead to a lot of open questions, a lot of arbitrary and inconsistent applications. Then the law contributes to nonobjectivity. This is where the practical applications are subjected to different policies, different interpretations, different decisions from one regulator to the next. I think our current model law is particularly open to the manipulation by balancing charges and interest. I understand the mortality charges can be manipulated to produce effectively higher front-end loads. I think it was John J. Palmer in a recent article in the *Actuarial Digest* who said, "In effect, there are no meaningful cash surrender values produced by the model regulation." A knowledgeable consultant told me a couple months ago that it was in his experience that most states cannot interpret a complicated application of a flexible premium interest-sensitive product. Because of this it is not impossible to get a nonconforming product approved. When you do have a conforming product, you can't get it approved because the regulators don't understand it.

All this complexity is difficult for the regulators to deal with and it is very costly. It makes marketing our products obtuse and not very client-friendly. I think that these types of limitations suggest that our laws are an ashen set of regulations. They are especially limiting us as we now have to compete with other financial institutions, such as mutual funds and banks. The financial business as we all know is becoming more global and we can look forward to some foreign competitors to join the party. We have got to ask ourselves whether the other domestic institutions or the global institutions have a competitive edge on us simply because they don't have the complexities of something like a nonforfeiture law to limit them. You have got to remember that overregulating an industry and putting it in a straight jacket can lead to not having a very healthy industry to regulate.

That's a laundry list of problems, but there are others. Let's examine why these will continue to give us problems. The big factor is that we are in a key and a very dynamic environment now. In any one year you see some changes, but if you look at them over a five- or ten-year period, they are simply overwhelming. With variable life coming along and then universal variable life, it's incredible the change we have had. Yet, with this change, it takes a decade plus or minus a year, to recognize the need for a change, to study the possible solution to determine what we should implement. A current example is the traditional universal life policy. It is very close to its tenth birthday, yet various actuarial task forces are still debating some of the issues ten years after the fact. When and if they agree on recommendations, then what happens? You have to walk through the NAIC process, then state-by-state legislative process. I really should have said two decades plus or minus a few years. Can you imagine that? We have a business, and it takes 20 years to get some change that is a very integral part of our product structure.

I talk about each new generation of products whose nonforfeiture law is heralded as the one that will effectively guide us for decades. The fact is that nonforfeiture laws have failed us to date, and because of their detailed nature, they have mostly been obsolete on the day they were implemented. When we looked to the 1980 revisions, the trivial cash values were gone and we could handle higher interest rates, gender-based mortality, and nonsmoking mortality. But a lot of us in the profession had to guess what to do with that stuff. Now we are saying, "We'll get one more big change to handle the interest-sensitive products and we'll coast for the next 20 years." I suggest there is plenty of change still ahead of us, real change, the kind you can't extrapolate. You can't even define where it's going and I might ask you to consider how the nonforfeiture law is going to handle things like underwriting and mortality based on genetic characteristics. How about when you find out about all the viruses that cause cancer? What's that going to do to the nonforfeiture structure and our product structure? I think the AIDS virus is a part of that picture. There's a lot of talk about secondary markets and about giving death benefits while somebody is still living because of terminal illnesses, and other things. What will the nonforfeiture laws do there? Will they sit up and answer the questions, stop us, or throw us into years of arbitrariness and nonobjectivity?

There is another aspect of these types of regulations I want to bring up. We are all familiar with the rule of law. In simplified terms, I think what that means for our industry is that the regulators should be guided by a limited and fixed set of principles that are communicated in advance and understood. So those regulated can foresee with pretty good certainty how they will be regulated in a given circumstance and plan their business accordingly. By this standard many aspects of our nonforfeiture law do not fit this principle. Instead, we have instances of nonobjective regulations important to our business which differ from state to state, from one regulatory body to the other. This nonobjective law can lead to arbitrary decisions and interpretation. This kind of arbitrariness is what I would call regulation by men and not by law. That is something to be avoided at all costs.

Although the standard nonforfeiture law has been around for well over a century, from the 1970s on they have been actually counterproductive in maintaining financial integrity of our companies and meeting the needs of our customers. How can we realistically improve this situation? Here are some broad fundamental changes: (1) Let's scrap the current nonforfeiture laws. (2) Let's publish general guidelines and simple frameworks for nonforfeiture values. Let competition do its job. We should encourage companies to provide for appropriate disclosure in communication and keep the process simple and understandable. I wish I could stand here and say, let's just fine-tune what we have, but it is clear it won't be done. A basic change is needed; otherwise these principles I have mentioned will not be addressed. You know a frequent fine-tuning as suggested says, "Let's drop the minimum cash value, but let's keep the paid-up." That's one you hear often. That's got a lot of appeal, but it really only addresses one main issue, an important one. That's the disintermediation risk. We are still left with all the other problems that I mentioned. We would have to establish guidelines and frameworks. An analogy might be helpful here. I can see that when you put up the nonforfeiture law situation, it is like you're setting up a highway system with traffic lights and road signs. But in a highway system, you don't tell everyone where to go. Our laws have been telling us where to go in very great detail. What we might consider is something along the line of a nonforfeiture actuary who is to nonforfeiture values what a valuation actuary might be to the reserving process.

Competition is a great motivator and provides an arena for meeting the mutual expectations of a lot of people and institutions. We ought to harness it and let it work for us. There is a lot of recent experience that shows when you have half regulation and half competition, things don't work out too well. I think the real choice is guidelines and lots of competition; or if there is no competition, let's have a lot of regulation. But a lot of regulation and a lot of competition is ridiculous. For instance, public utilities are heavily regulated because they are precluded from competing; on the other hand our industry is very competitive. The better way is to go with broad guidelines and let it work in harmony with this very, very competitive environment. Now to help competition work, we ought to, as I mentioned earlier, work on disclosure. Get more information to the clients, to customers; we've got our interest-adjusted cost. A microcomputer is very powerful. You give new agents a disk and they call you back in a half hour and say you have a lousy product or you have a good product. It's not a big mystery anymore. What would the world be like without nonforfeiture law? I say it would be a world with better products; it would mean simpler and more understandable contracts; there would be a better balance between the interest of terminating and continuing policyholders; all the companies would be better insulated against financial disintermediation; the regulatory process would be free to deal with important issues; there would be lower company and regulatory costs; companies would be better able to meet the global challenge. Also there would be fewer trips, letters and phone calls to state capitols. For those who haven't attained your FSA yet, the actuarial exams would be simpler.

Let me conclude that in our industry, we have experienced this incredible change and we will experience a lot more change in the next decade. Isn't it reasonable that maybe the regulatory process will change a little bit? Why should all the change be in the nonregulatory area? Our nonforfeiture approach today was created before computers, variable products, and interest-sensitive products, and before the advent of gender based mortality and AIDS. I'm not talking ancient history; I'm talking the last four or five months. As we move onto these uncharted waters, I urge that we work and strive for more responsible and flexible nonforfeiture approaches to meet these challenges. I'm not against regulation. I think appropriate regulation should be supported.

It should be supported just as hard as inappropriate legislation should not be supported. Without the elimination of nonforfeiture values it will be more

difficult for us to survive as sound companies and more difficult to serve the public.

MR. WALTER N. MILLER: I was very interested in Mr. Bourdeau's highway analogy. It seems to me that Mr. Bourdeau's concept of deregulation using this highway analogy is similar to like saying, we should set up some highways without directional signs and traffic lights, with no physical way of separating traffic moving in different directions. There may be better ways to "skin the cat." Without intending to, Mr. Bourdeau may have also told us something very significant about the Society of Actuaries. He said that one of the things that is a hallmark of insurance regulation in this country is that it moves either very slowly or never. He was telling us that the Society is even slower than that because it is a matter of fact that the new Nonforfeiture Committee that I currently chair was formed at the explicit request of the NAIC Life and Health Actuarial Task Force. It is, I think, in a posture of agreeing, at least in considerable measure, Mr. Bourdeau, with your thesis number 1, that what we ought to do is scrap the current law.

One of the best definitions of effective regulation or the case for regulation that I have ever heard is a short and simple one. It says that regulation is direct interference for providing a direct impediment with the normal operations of a free market done so in the belief that society will be better off. So I guess the question before the house is how should we evaluate that trade-off with respect to the nonforfeiture laws and regulations? I think my thesis is purely pragmatic. Folks let's face it, in the real world for a variety of reasons, some of them good and some of them bad, society is not ready to make the trade-off of eliminating this sort of impediment so that the market can operate totally free. Whether we like it or not, that isn't going to happen. Our task is to try to shape the real world as best we can for the benefit of the various parties of interest: our professional interest, our employer and client interest and our policyholder interest. At its first meeting, our committee very quickly agreed that if in fact there were an active and effective secondary market for nonforfeiture benefits, then that would be ample reason for proclaiming loudly and clearly to anyone who wants to listen that, for whatever it's worth, this committee thinks there is neither a theoretical nor a practical reason to have minimum cash for nonforfeiture value legislation.

Now let me do something which I think I am forced to do because I am surrounded by two representatives of Tillinghast, but which I would like to do. Like many of you, I am a great fan of Jim Anderson and have been for a long time. In the October 1987 issue of *Emphasis*, Jim has a page of comment that touches many of these issues. I want to read to you a couple of paragraphs from the section titled "A Secondary Market?" "Notwithstanding the precedent, (and here he is referring to historical precedents in the U.K. many many hundreds of years ago), a secondary market would not be easy to organize. Besides possible legal challenges based on public policy or other grounds, the tasks of assembling and evaluating medical evidence, reviewing policies, documenting the transfer, and assuring timely payments of future premiums are permissible and likely to be expensive. Nevertheless a few organizations might be prepared to offer such a service. Part of the needed capital could be obtained by exercising the loan provisions of the policy's purchase. A better alternative would be for the service to be provided by the life insurance industry itself. Problems of assembling and evaluating evidence would remain, but many of the other problems would be simplified or even eliminated if companies dealt only in their own policies." Folks let's face it, whether we like it or not, society does not trust the life insurance industry and we will not be allowed to run a supposedly semiobjective secondary market with respect to negotiating cash and nonforfeiture values on our own policies with our own policyowners, absent any regulation. It isn't going to happen, at least it isn't going to happen during the time frame that I think we are here to consider.

One of the reasons that I was pleased and flattered to be asked to be chairman of the new Society committee is that I have been for a long time a very strong proponent of the proposition that one of the Society's biggest problems is enhancing and even maintaining its own professional identity. We can talk for a long time about the turf problems that the actuarial profession is undergoing. I think those are well known. I was delighted to have an opportunity to get involved in this project because I think it is one where the Society, through this committee, can make a difference in the real world and agree, perhaps more strongly than the current regulators do with Mr. Bourdeau's basic thesis, that the current laws need to be scrapped. We are going to make a difference in the real world. I don't think we could if we ended up merely saying that the best way to solve these problems is to just throw the whole thing away.

I would like to tell you a little bit about where our committee is at because we really do seek your input on these questions. I would like to tell you where the committee is at right now on the basic question of should there be a minimum cash and nonforfeiture value regulation? I'm quoting now exactly from the minutes of our last meeting, an exhaustive and intensive, highly analytical two-day meeting held not so long ago. The committee discussed these questions again and that's very significant because we have discussed these questions, rather intensely, at every one of the four meetings that we have had in the relatively short time since we have been formed. I guess I have to warn you, for better or for worse, that what I am about to read may not be the final opinion of our committee, but it's the way it seems to be coming out. "The committee agrees that there is no theoretical, actuarial reason for having prescribed minimum nonforfeiture values. Nevertheless, given the apparent position of the regulators and our committee's desire to make a difference, recommending no minimum values at all may not be practical in the U.S. We are concerned about restricting the insurance industry's ability to compete in the financial services industries. The committee has a strong desire to make recommendations that will permit experimentation with no cash value coverages and perhaps no paid-up benefit coverage."

Let me close by returning to three of Mr. Bourdeau's statements and perhaps explain why this may be more of a nondebate. (1) Let's scrap the current law. I think a lot of the players in this game are in significant agreement on that. (2) Let's publish some guidelines and simple frameworks. The publishing of guidelines and simple frameworks would translate quickly into minimum standards. I think our committee is agreeing that we should try to have some minimum standards and that they should be as simple as possible. (3) Let competition do its job. To the maximum extent feasible we certainly agree with that. I also think it is fair to say that our committee believes that the emerging framework on forfeiture regulations ought to make adequate allowance for letting economic forces, many of them beyond our control, have an appropriate effect.

MR. BOURDEAU: We have to admit that if we changed the laws it would be an incredibly tough job; nobody is saying that it wouldn't. In fact any time significant laws have been changed there has always been a precipitating crisis. All the savings and loans almost go under, so they decide to change the law; they'll do that sort of thing. I just hope by taking a solid position and getting

behind them we don't have to wait until we have a couple of our large companies underwater. Things can get tough and they are very competitive today. It's a shame, as we compete, that things like tontines and semi-tontines are precluded by law. They used to be very popular. I remember in my product development days, we created very clever tax and estate problems that could be dealt with through tontines. We have a lot of people today that don't want life insurance, they are scared to death they are going to live until 80 years of age, so a tontine payable at 80 would be perfect. All the guys that die would be contributing to him at 80; he would be very happy. These would be incredibly great products for our industry that the banks, mutual funds, and no one else would have. We are writing them right off because of a law. Mr. Polkinghorn was saying he did a little research and shared with me that the reason they stopped the tontines was that people loved them but the companies didn't reserve for them. I think a hundred years later maybe we can reserve for them. With computers, instant communication, modems and real time systems it is an incredibly different world. It's a shame to lose those opportunities. The SEC has minimum cash values. We don't like them because they don't fit our business, but they are very simple. I don't see, especially with the interest-sensitive products, why we couldn't go that way.

There is one other thing I want to comment about. I didn't suggest we wouldn't have traffic lights or anything, but even if we didn't, it wouldn't take the public but two or three days to sort it out. There would be an article in the paper saying, "There is no rule, but stay on the right side of the road," and everybody would. That's what is called spontaneous order. Lately there are people studying that in society, and there are many instances of very sophisticated human actions that go on with no explicit framework. The English language is dynamic; it's continually evolving. There are allowances for regional differences, but have you ever seen any regulations as far as proper English usage is concerned? I implore you not to suggest to your legislators that they promulgate regulations concerning the English language. The only point I want to make is that, for an incredibly complex dynamic situation to thrive and prosper, it needs spontaneous order. People like to survive and do the right thing and they do.

MR. MILLER: It is possible to observe the fact that companies offered tontines which were usually successful, but when the companies didn't reserve for them,

that was an example of a free, completely unregulated, market at work. Look what happened, and there may be a lesson there.

MR. ROLAND A. DIETER: I think in today's environment we wouldn't have this problem you allude to about the nonregulatory atmosphere. I feel that people today are much more educated. Probably what would happen is there would be consumer organizations for profit that would rank the companies or products. Insurance companies would be asked about their practices. Do you reserve? How do you reserve? I think buyers would then make determinations before they would enter into tontine arrangements. Mr. Miller, you very quickly mentioned that in the committee you would go so far as to allow no cash value insurance and no minimum reduced paid-up insurance. I don't understand why the no reduced paid-up. I feel that it promises to be paid in the event of death which presumably is not controlled or wouldn't become controlled, so why would it not be reasonable to require minimum paid-up benefits? I have assumed you mean death benefits.

MR. MILLER: I said the committee at this point is considering the possibility of allowing experimentation with policies that provide no cash values and/or no paid-up values. This group can do our committee an awful lot of good by thinking about what you have heard here and giving us all the input you have. Please, listen closely, particularly about where our committee is at. We are nowhere close to final conclusions; I don't want anybody to think that we are following devious routes to foregoing conclusions. There are some important issues where frankly the mood of the committee at one meeting has almost been 180 degrees different from the mood at a prior meeting. So yes, we are going to get a report out about a year from now, and we are going to fulfill that part of our assignment, but it is not close to being frozen in stone. We need help; listen closely to what we are considering.

MR. POLKINGHORN: I would like to add a quick comment. The paid-up benefit defined by the standard nonforfeiture law, as it exists today, causes a substantial increase in the premium for a zero cash value whole life product. You are basically taking paid-up values that are associated with plans of insurance that have $13, $14, and $15 per thousand premiums and imposing them on a plan that otherwise would have $3 and $4 per thousand premiums. The cost of the paid-up benefit is substantial. I think that people would want to offer policyholders

the choice of a policy with a paid-up benefit or without, but at two different premium rates so that those who want it pay for it.

MR. MILLER: One of our committee's current research projects is to figure out, under a wide variety of scenarios, what we might conclude about the cost element for various types of cash and nonforfeiture benefits.

MR. TED BECKER: We have a law in Texas, just passed this year, that under certain conditions permits life insurance to be sold with a face amount of $10,000 and over, with no cash values or paid-up values or loan values and with guaranteed premium rates. This is going to be superimposed over another system with the traditional nonforfeiture law. I am very interested in whether competition is going to work with this type of product. It seems to me there is no advantage to it unless the premium rates are reduced substantially, yet there is no provision in this law forcing a premium reduction over what the company would charge for a similar policy which has cash and other nonforfeiture benefits and loan benefits. There is even a more frightening specter of what happens if the company sets its premium rates too low. So as a regulator, I feel there is a lot of concern whether competition will work and whether it might work too much and reduce premium levels below what they should be. You have two different extremes to worry about rather than just one.

One of the problems with tontines was that people were given illustrations that the lapse rates were going to be level in all years. People would come in, their policy was 20 years old, and they had a sheet with a list of dividends and it showed the same percentage of people lapsing the 17th and 18th years right before the 20th year distribution. If you have tontines, there are some special problems that have to be addressed in the area of disclosure.

MR. MILLER: I think if you look at some of the romantic universal life illustrations that are floating around today, they look like tontines.

MR. BRADFORD S. GILE: I'm not involved in life insurance right now, I'm involved in health insurance, but I have been very closely interested in the question of nonforfeiture values and life insurance. I think the question as to whether the marketplace will probably regulate nonforfeiture values is not a purely theoretical one. I think it is one that can be addressed right now. The

current product is universal life insurance which today has, at best, a regulation promulgated by the NAIC in 1983, which I would submit is not a regulation at all. I think we can now observe a product which in fact is totally unregulated in its cash surrender value and other nonforfeiture benefit structure. My own personal observation is that there are products like universal life insurance which do have extremely unusual cash surrender values; things which I would not think could possibly survive as traditional life products. In fact they couldn't possibly meet the standard nonforfeiture law for life insurance. At any rate, I would strongly suggest that those who are interested in this question and are interested further in the question as to the impact of the marketplace, should in fact look at what's there right now in universal life insurance and come to their own conclusion.

MR. HOWARD H. KAYTON: Mr. Bourdeau stated one advantage of eliminating nonforfeiture laws would be to make the syllabus easy. It probably wouldn't; they would add the history of nonforfeiture laws. Wouldn't that be exciting?

You mentioned that the competition wouldn't force cash values; I think the place you ought to look at really is annuities. The single premium deferred annuities have not required cash values for the longest time and yet there is no one out there issuing a no cash value annuity. Furthermore the laws, even the 1980 laws, permit you to take a loading on flexible premium annuities of something like 35% of the first year and then grade down in renewal years; yet most annuities are zero load annuities with nonforfeiture values that grade off, or surrender charges that grade off. I think the real practical solution to this (you mentioned before that the consumer can't understand no cash value life insurance policy) is to have minimum size policies, for example, a $100,000 policy or some minimum amount. Also, if you eliminate cash values you obviously have to eliminate loans as well; you can't have one without the other. I'm not sure that there would be an immediate decrease in premiums, but I think competition will force a product that will give the consumer a fair value.

MR. POLKINGHORN: I have heard a couple of times the topic of disclosure and zero cash value whole life. Mr. Miller had indicated that consumers wouldn't understand it. I'm not sure I got that out of your comments Mr. Miller, but in any event, I can't think of a product that is simpler to understand. You pay a level premium and if you die you get a death benefit. There is no argument

over your 20th year cash value being projected correctly; it's zero. From that standpoint I can't see anything that is simpler from a disclosure standpoint. The area where you get into problems would be if you had no regulation regarding nonforfeiture values, what's to stop a company from doing as they do in Canada by saying there are no cash values until the 20th year? Then they appear. Or there are no cash values until age 65 and then they appear, but then there is none at 66 and later; you just have a one-year window. There is a lot of innovation, but the basic zero cash value life would seem to me anyway to be the simplest product to understand from a disclosure point of view.

MR. LARRY N. STERN: I have a number of comments I would like to make. First, the market in Canada hasn't seemed to fall apart as a result of zero cash value life insurance policies being marketed. They are being marketed very successfully. In the United States we have seen a number of products masquerading as cash value life insurance which are not true cash value permanent type coverages. They are term with the participating dividends keeping the premiums level throughout the lifetime of the contract. With a regulation that would allow zero cash value permanent life insurance to be marketed, I don't think we can do a better job at providing the public with a permanent life insurance product regarding adequate disclosure. As Mr. Polkinghorn was saying, it would be very simple to explain that you pay a level premium, which is a desire of the insurance buying public, and you get a death benefit as a result of it. I think with that kind of a regulation, there would be a more direct way of developing products and it would be at a more fair premium to the buying public than the way some products are being sold today.

Other things that weren't really hit upon, but would result from zero cash value life insurance, are the investment strategies for companies. They could certainly take the premiums in and go toward longer term investment strategies because they wouldn't have to worry about the disintermediation risks that result from cash value or paid-up benefit provisions. I think we would truly see the end of the so called trivial values that are created by some coverages that are being provided under contracts today. Who is to say that $2 or $3 a thousand is really a value that a policyholder thinks about and knows is there and wants to borrow against or surrender the contract for it? He's buying the policy because it's providing basic, pure protection. As a result of the current standard nonforfeiture law there has to be this trivial value that is being

provided. We see a lot of times the decrease in term coverages at the older ages because of the trivial values that are created by the standard nonforfeiture law. Companies tend to shy away from products that are providing those trivial values. Another thing regarding adequate disclosure is if we offer products with cash values and without cash values and then tell the public with adequate disclosure that there are contracts that they can buy and the premium reduction is 30% to 40%, they will be the best judge of where they want to put their money. There are estate planners and financial planners out there that like to sell coverages from a pure protection standpoint and they don't want the cash value to be there. If the buying public can get that kind of coverage for 30% to 40% reduction in premium, perhaps the public would make those choices.

Other forms of insurance have been successfully marketed in the U.S., such as health, property and casualty, and disability income coverage, which are sold for a level premium and the coverages don't require cash values. The buying public has been buying them and has felt very secure in buying them for years.

MR. JAMES F. REISKYTL: I haven't given a lot of thought to this subject before today other than to the point Mr. Miller has made. It seems to me that the guaranteed value is a function of premium. It immediately takes us into things like price fixing. Somehow my logic tells me that at age 35 if you charge $3 and you don't have a cash value that's probably one thing; if you charge me $400 and you don't give me a cash value that's another thing. You may have great faith in competition. I think it works imperfectly, and yet sometimes it works well in annuities. I'm not sure it works equally well in life insurance.

Second, I'm trying to figure out the thing that's been increasingly concerning me in the area of guarantee funds. When I was in Canada they did not have guarantee funds, but they are thinking of putting one in as I understand, given certain conditions. I'm trying to figure out whether we are better off letting people price contracts with or without guarantee values and then letting the guarantee funds pick up whatever is left on the floor.

The third point that comes immediately to mind is the continual efforts of Congress to say that the actuaries are all loading up on reserves and obviously they shouldn't be permitted for tax purposes in this country. Again the Canadians are in the blessed position, at least to date, where they have had to

pay little, if any tax and that may be changing. It would be interesting to see how much enthusiasm there is for such a product if in fact there is no deductibility of reserves and the only deductibility is if you pay cash values. If we break that barrier we have a new set of problems; it just adds a little practical tension to the other comments that you mentioned earlier, Mr. Miller. I agree there are other issues that must be discussed.

MR. DOUGLAS W. TOZER: I would like to ask a few questions of our Canadian friends in the area of new nonforfeiture benefits since they have been selling this here for a fair amount of time now. Are you running into the problems that your competitors are underpricing your product because of not having cash values in them? Or on the other side of the coin, are you running into any problems with your competitors such as when the products get older are they encouraging their policyholders to possibly lapse their policies because the policies have reached the stages where they are worth more to the company off the books than on the books?

MR. POLKINGHORN: The answer to your question is yes, there will be a panel sponsored by the Reinsurance Section to talk about the risks of lapse supported products. There is a concern in Canada that your competitors, by assuming a higher lapse rate than you do, can sell the product at a lower price and perhaps at an unsound price. That tends to be more the concern in Canada than if a policyholder is entitled to a nonforfeiture value when he leaves. I guess to contrast I would ask, can a company in the U.S. sell a universal life product with too high of an interest rate to beat out their competition that is perhaps unsound? I frankly don't see much difference between the two. Unsound pricing is unsound pricing, poor disclosure is poor disclosure, unfair trade practices are unfair trade practices and they can apply to all products.

MR. MILLER: Let me restate some of the mile posts we may be at. Remember nothing is final. In terms of recommending minimum standards for cash and/or nonforfeiture values, what sort of characteristics should these standards have? I have four listed here. Once again the theme of pragmatism runs through these very heavily. (1) The minimum standards should be according to formulas that can be set at issue of the policy. (2) If there are variables entering into these formulas, the method of determination of the values of these variable quantities should also be defined at issue of the policy. (3) The standards, if there are

to be any, should avoid obvious unfairness between persisting and terminating policyholders. (4) Finally, the standards, if there are any, should avoid obvious unfairness between different purchasers of similar policies. That leads directly to another kind of tentative point that our group has reached and this is on methodology, retrospective versus prospective.

I think there were probably some people who expected the next attempt at revising cash and nonforfeiture value minimum standards would be to recognize the obvious inapplicability of the current law to set up some retrospective approach for universal life. Many may feel that we should leave the current law alone for traditional products and develop a modification for universal life. If we are trying to work from a principle to avoid obvious unfairness between different purchasers of similar policies, our committee believes quite strongly at this minute that if you try to set up formula A for class A policies and formula B for class B policies, there are inevitably going to be enough gray areas and fuzziness in the middle where policies can be either A or B. One of our very strong objectives right now, and I don't know if we will be able to achieve it successfully, is to have the same basic methodology for all types of policies.

One other thing the committee has a good deal of comfort with now, once again recognizing it could lead to a lot of practical problems and not having the specific scheme in mind, is the fact that currently most of us think there should be something in minimum standards that will recognize the impact of economic conditions on a company's stability to deliver cash or nonforfeiture benefits. Finally, we are once again considering three types of basic concepts as to the type of benchmark that could be used for minimum standards. What sort of animal are you trying to reproduce across this enormous broad spectrum? One of them is the asset share, the other is what we within the committee are calling the company indifference value. If this amount is paid out on termination, the company doesn't care if the policyholder terminates or not. The third one is what the committee calls the auction value, which is our best guess as to the type of value that might be obtained if there were in fact an effective, objective and active secondary market. The three basic concepts I have just read off in very simple circumstances, with very simple policies, and cookbook assumptions, produce results in declining order. Asset shares seem to be higher than company indifference values, which in turn seem to be higher than auction values. We may find in the work now being done that this doesn't hold up in all cases.