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WHAT WILL BE THE LIFE INSURANCE PRODUCTS OF THE FUTURE?

Moderator: BRADLEY M. SMITH
Panelists: DOUGLAS C. DOLL
JOHN J. PALMER
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Recorder: BRADLEY M. SMITH

- Trends in life insurance products in the 1980s have included graded premium whole life, universal life, excess interest whole life, variable life and single premium whole life
  - What product trends will arise in the 1990s/21st century?
  - Are there profitability trends associated with these products?
  - Will the investment risk be passed to the purchaser or retained by the company?
  - Will there be more emphasis on living benefits (i.e., nursing home/dread disease riders)?
  - Effect of AIDS on product design
  - Effect of regulatory bodies on product design
  - Effect on mortality improvement/medical breakthrough on product design

MR. BRADLEY M. SMITH: This open forum is sponsored by the futurism section following a question and answer format. Specifically, two panelists will address a particular question, hopefully identifying differences in their points of view. Subsequently, the question will be thrown to the audience for any input that you have. Finally, we'll conduct a straw poll on a couple of the questions.

We have a very distinguished group of panelists. John Palmer is a Fellow of the Society of Actuaries, a Member of the American Academy of Actuaries, and Senior Vice President of The Life Insurance Company of Virginia. He is currently responsible for product management, which includes, in addition to product development, investments, sales promotion and reinsurance. Previous positions at Life of Virginia have involved pensions, group insurance, corporate planning, taxes, and financial reporting. He has been active in numerous industry groups addressing federal tax law changes since 1980. He is currently chair of the American Academy of Actuaries Committee on Life Insurance and has served as chair of the Council of the Society's Individual Life Insurance and Annuity Product Development Section.

Godfrey Perrott is a consulting actuary in the Philadelphia office of Milliman & Robertson, Inc. He began his actuarial career with Milliman & Robertson in 1964 and transferred to M&R Services, the data processing affiliate of Milliman & Robertson, at its inception in October 1968. From 1984 to February 1987 he served as Executive Vice President and Chief Operating Officer of M&R Services. Godfrey's particular areas of expertise include financial reporting, administrative systems (both life and health), appraisals, product development and tax planning. Godfrey is a graduate of Cambridge University, England. He has been heavily involved in the Education and Examination Committee of the Society and has chaired other committees. He is a Fellow of the Society of Actuaries and a Member of the American Academy of Actuaries.

Doug Doll is a Fellow of the Society of Actuaries and a Member of the American Academy of Actuaries. A University of Illinois graduate, Doug is a consulting actuary in the Jacksonville office of TPF&C. He is a member of Individual Life and Annuity Product Development Council and has served on various committees and task forces dealing with valuation and nonforfeiture.

Our first question will be addressed by Doug and John and deals with the shifting of investment risk. Will companies attempt to shift more of the investment risk to the policyholder by emphasizing variable products and products with market value adjustments upon withdrawal? Universal Life brought the separation of the savings and protection components of the whole life policy. Will this separation continue? Why or why not?

OPEN FORUM

MR. JOHN J. PALMER: The shifting of investment risks to policyholders can be viewed as having occurred in three main waves and one mini-wave.

Par policies have been designed since their inception to effectively shift risks to policyholders. The shifting of the investment risk to the policyholder, at least in the negative sense, has been more latent than real until recent years (which is the first time it has really been needed). This shifting has been reflected first by direct recognition of policy loan activity and more recently by reductions of dividend scales on account of variation in investment results from those assumed in the original illustrated scales.

Variable life policies are perhaps the ultimate in shifting investment risks to policyholders. The original motives for the variable design were less to shift the existing risks to policyholders than to allow for the sensible use of more risky investments to flow through to policyholder values.

The advent of universal life was perhaps the third major wave in this risk shifting. In this case the motive was to shift existing risks which, because of the economic environment, had become otherwise unmanageable on a price competitive basis for fully fixed guaranteed products.

The mini-wave referred to was the introduction of modified guaranteed life and annuity products, which provide for a market value adjustment. These could be viewed as a hybrid between variable life and universal life. So far the wave is "mini" because of the limited regulatory enablement and market penetration of these products.

A company's desire to shift the investment risk to the policyholder might be viewed as being based on two primary factors: (1) the size of the investment risk involved, and (2) the ability (or lack of ability) to charge a fair price for assuming that risk.

As for the size of the risk, with respect to risks on nonregistered products, the recent brief period of relative tranquility in the investment environment has seen the emergence or re-emergence of a number of guarantee features (secondary guarantees, longer term interest rate guarantees, and so forth) but substantial risks are still present in our business, most noticeably due to the use of junk bonds and to the necessity to mismatch assets long in order to deliver marketable products.

Risks under registered products are perhaps even greater than at the introduction of variable life in the mid-1970s. We've seen October 1987 and we've seen a wide variety of investment portfolios involving substantial risk introduced under variable products all of which are passed along to policyholders. Continued relative growth of these products can be expected, accelerated by a stable regulatory environment and continued experience in dealing with it, and deterred by more numerous regulations being imposed.

Turning to the second factor, the cost for assuming risks, it is still somewhat unclear whether the industry is, in general, charging the policyholder enough for assuming the risks that it has assumed. Many people would contend that we are still significantly underpricing our products by not taking adequate account of the cost of the options we're granting to the policyholders and the risks we are assuming to produce "competitive" returns. But it's tough to sell dollar bills for a dollar when others are selling them for 95 cents.

Our financial regulators (statutory requirements and the Financial Accounting Standards Board) still do not adequately require companies in the preparation of their financial reports to "pay" for the risks that are assumed by those companies.

The implementation of the valuation actuary concept and cash flow analysis may help, especially with respect to the C-1 and C-3 risks, by creating extra reserves and consequently, the necessity to charge premiums sufficient to fund those reserves. In fact, growing awareness of the magnitude of these risks appears to be leading to some price increase activity already, in the form of more nearly supportable interest rate credits.

We're going to face shortly I think the prospect of having to compete more closely with banks. Banks, possibly with the backing of the Federal Deposit Insurance Corporation (FDIC), are already beginning to compete effectively with us in the guaranteed investment contract (GIC) market.

The FDIC premiums are not risk related, hence, they are likely to be inadequate for some banks some of the time. Since the bank can shift its risks to the FDIC by payment of a possibly inadequate premium, it may tend to pass returns to its customers with a risk charge no more than the FDIC premium.

Will banks be able to produce functional substitutes for life company product investment elements with FDIC backing while we, the industry, are left with our so far "unadvertisable" state guaranty association backing? Possibly so. Of course, if the industry loses the tax advantage of inside buildup shelter, the possibilities of such a situation (that is, banks producing functional substitutes for our savings elements) would dramatically increase.

By way of conclusion, I think the industry will have to continue to shift investment risks to policyholders unless we either reach some utopian era of interest rate stability or unless the marketplace allows us to charge the proper cost for assuming these risks. The market probably will not allow us to charge the proper price until regulators require accurate explicit funding of these risks by way of reserving requirements, thus forcing all companies to take direct account of these risks in pricing.

Hence, companies will probably be forced by economic reality to shift investment risks to the policyholders. The rate of shifting will, as we have noticed in the past, be accelerated by an environment with interest rate spikes, or perhaps by a debacle in the junk bond markets, and will be slowed by boom times or by periods of prolonged stability.

It seems to me that unbundling the product is not the key issue, but is material in that it increases risks by focusing the consumer's attention on the investment element, thus encouraging disintermediation and shortening our liabilities at precisely the wrong time.

I believe we have pushed risk shifting nearly to current limits allowed by our current laws and regulations. New laws or regulations could certainly help, but reflecting of market value adjustment and cash surrender value will inevitably encounter Security Exchange Commission (SEC) problems. One possible regulatory change which might help would be the ability to sell zero cash surrender value policies.

All these issues will loom increasingly large in the years ahead. It is by now a truism that the consumer's fear of premature death is being replaced by a fear of outliving his assets. Thus products which emphasize capital accumulation, either directly (as with GICs or single premium deferred annuities (SPDAs)) or indirectly (as with long term care) will be the growth lines in the future. Unfortunately, we do not have a monopoly on these lines as we have on the shifting and distributing of the risk of premature death. But any individual's asset accumulation needs are still ultimately dependent on his longevity, so there should be substantial and growing opportunities for us in products which require our unique ability to bear life contingency risks.

MR. DOUGLAS C. DOLL: With regard to shifting of risk to policyholders, I agree with John that universal life and par whole life do shift substantial risk to the policyholder, but I think distinction needs to be made as to where this shift is coming from. Because part of the shift on universal life and even more so on par whole life is not a shift from the company to the policyholder but from one policyholder to the next, the policyholder who pays his premiums in times of high interest rates to some extent is subsidizing the dividends of the policyholder who paid his premiums at lower interest rates.

I agree, the company does maintain the minimum interest rate guarantee risk and also maintains the C-3 risk, which in this context could be viewed as a catastrophic reinsurance risk, because with minor C-3 risk, the policyholders are sharing it among themselves. Therefore, I think we need to keep in mind, if we want to transfer all risk to individual policyholders via variable life or market value adjusted annuities that, from the individual policyholders' point of view, he has gone from assuming a fair amount of risk to having it all transferred to him. The policyholder believes that the company is transferring all the risk to him when really the company is transferring only part of it. So I think the company is giving up some profit potential by the fact that it in effect can take credit for some of this risk sharing among policyholders.

John also mentioned the company's desire to shift risk being a function of the size of the risk and the price you can charge for the risk. He didn't say it directly but I think he mentioned it in

passing and I want to highlight this: It's not only a function of the price of the risk but a function of how much that risk-shifted product will sell. There are a lot of discouragements to a variable life sale. There are the extra disclosures that the SEC mandates that will effectively highlight to the policyholder what the loadings are. There is a lot of extra regulation and expense, and we shouldn't discount the consumer's reluctance to assume the risk. I've been told that in Australia, ever since the stock market crash, in the unit linked business, which is Australia's version of variable life, sales have dropped significantly. The Australian companies now are looking to develop universal life as a more saleable product there.

I'm not convinced that extra reserves being required on these products are going to force more realistic pricing. It may to some extent, but I don't think it's going to go nearly as far as we'd like it to. In fact, we still will have the current situation unless the evolution of the valuation actuary techniques progress us further. Some forms of extra risk may not require extra reserves, for example, investing in junk bonds, at least under the New York Regulation 126 calculations where you're permitted to deduct a flat extra default risk charge for investing in junk bonds. You really haven't had to hold any extra reserves for the fact that you're investing in junk bonds. Now if it progresses further and the actuary has to take into account the fluctuation of junk bond results, then maybe we'll see it. But I'm not convinced that the extra reserves are going to force more realistic pricing, at least in the short run.

Furthermore, in the absence of another interest rate spike like we had in the late 1970s and early 1980s, I believe we'll probably settle down to some sort of semi-comfort on assuming the C-3 risk. It's interesting, now that we're a few years past 1980 interest rates, when we do scenario testing of interest rates, the view seems to be more and more that the 1980 spike in interest rates was not a reasonable scenario, and you tend to discount that scenario in future pricing. I believe that the industry will not easily give up the source of profit that's available to it by mismatching assets and liabilities. Instead, I foresee companies trying to manage the asset/liability mismatch risk somewhat more by putting into products greater disincentives to lapse. We're seeing that already with the advent of persistency bonuses and I think we'll see surrender charges probably become larger in the future as well. Right now most universal life products do not have surrender charges as large as the standard nonforfeiture law would permit them to.

Going back to the issue of extra reserves forcing more realistic pricing, it's possible that when regulators get more comfortable with the valuation actuary concept, we may even see life insurance companies assume more risk than they're permitted to now. For example, we might see somewhat more investment in equities than we have now if regulations will permit it. It may be that the amount of extra surplus you have to hold, to back the extra risk from investing in equities, is not sufficient to prevent equities from being a more worthwhile investment from an expected value point of view than the traditional investments such as bonds and mortgages.

Regarding the separation of savings and protection, Brad's question asked if we thought that this would continue and I'd have to say very strongly "yes" if for no other reason than it was brought home to me late last year when my parent company, Towers Perrin, instituted a group universal life plan as part of its revised benefits package. We had a representative from the human resources department come to our office in Jacksonville to explain to us what our new benefits were. It was amazing that the most wonderful benefit we were getting was this group universal life plan. She took great pains to explain it exactly as term insurance plus a savings account. She was saying how she had withdrawn her money from the savings account in the bank and put it all in the group universal life and it was her savings account. So I think the advent of group universal life among various companies (and it seems to have grown quite a bit lately) will go a long ways towards educating people on the separation of savings and protection.

Similarly, I think par whole life has contributed to that separation. We've seen many of the mutual companies now come out with a combination of whole life, term insurance and paid-up additions rider whereby the policyholder, if he's smart or if the agent lets him, can effectively select the components of protection and savings in the plan. We continue to see consumers become more financially sophisticated. There are more and more financial magazines available in the popular press that will also highlight the separation of savings versus protection.

The issue, of course, is that this unbundling exposes the cost components of the product. At least it did on early versions of the universal life, although companies are now trying to hide the cost components back a little bit. The challenge to the industry is to convince the consumer that the

savings component also has protection elements, for example, the guaranteed investment results. I think if we do a good sales job there, then we can continue to sell the savings component and continue to retain significant margins in it.

As a final point, I just want to mention the convenience factor of the life insurance policy with combined savings and protection. Sometimes I think we tend to overlook how much convenience is worth. I know personally, I have a bank money market account that's only paying 6.5% even though I know I can get 9% going elsewhere. But I like the convenience of being able to go to that bank and instantly transfer money from that account to my checking account on days that I happen to discover that I have overdrawn my checking account.

My conclusion with regards to the separation of savings and protection is that I think we are going further towards the unbundling but I do not see that diminishing the importance of the savings element in life insurance policies as much as some people might believe.

MR. FRANK S. IRISH: To oversimplify, Mr. Palmer says that we're going to give away these risks because we can't manage them and Mr. Doll says we're going to keep them because they're so profitable. I'll add some considerations that they might also take into account. First of all, the growth of guarantee funds certainly encourages us to hang on to risks because we don't have to pay for them. On the other hand, there is the detailed attention that has been given to our industry by an increasing variety of rating agencies. I think they will take a look at the amount of capital that is needed to support these products and look at the imbedded options that we are giving away and make us set up the proper amount of capital, which brings me to my final point. I think that if things develop in this direction and there is an increasing understanding of the amount of capital that we should be holding to support these risks, and we certainly do want to take on these risks if we possibly can because as Mr. Doll says the profit opportunities are very attractive, then the key factor overall is the amount of capital in the industry and whether there is sufficient capital available to expand the kind of investment risks that we take on. Right now, I would suspect that we're rather short of capital as an industry, but in the long run, perhaps we will not be and perhaps simply the extra capital that we're carrying will make it very tempting to take these additional risks.

MR. DOLL: I know there have been seminars on capital and managing capital and whether or not the industry has enough capital. Unfortunately, I didn't attend any of those, so I'm not sure whether the consensus is there's too much or not enough or how the industry can get more. It seems that more and more new ways of raising capital are being devised. I have to believe that, if the return is there, eventually capital will find some way to get there also.

MR. PALMER: I haven't attended those seminars either but I was on the planning committee for a Life Office Management Association (LOMA) financial officers forum that's going to be held next spring or early summer, and the whole framework of that forum will be capital issues: raising capital, do we have enough and where is it going to come from. I think that reflects what the commentator noted: that there is a growing perception that capital is short.

I have an additional comment on the rating agencies. That's certainly turned into a boom industry. Every rating agency is beating down our doors convincing us we need to buy their service. They do look through statements a lot more realistically than do some of the other kind of evaluators we've had in the past. They do take account of the kind of imbedded risks, the options, how much GICs business you've got and the kind of risk associated with the various kinds of product lines you have, on a more refined basis than some of the other regulators.

I'd like to make a couple of comments on some of the things Doug said, not by way of rebuttal. With respect to sales in the U.K., we have an affiliate operation there and based on a little observation, sales of unit linked business does not seem to have slowed down too much. The people there have some products (a series of pension products, sort of super individual retirement accounts (IRAs)) that have been enabled by recent legislation. As a result, there's a current boom of sales of that kind of product on a unit linked basis. Also there's a mini-boom in mortgage endowment policies, that is a life cover but with a funding that produces an endowment to pay off the mortgage. These are generally sold as tie-in sales with the entity providing the mortgage funds. The bank and the insurance company are all hooked together, so you get your mortgage funds from the insurance company, in a manner of speaking.

With respect to Doug's comment about refinements to reflect the quality of investments, junk bonds let's say, the Special Advisory Committee on the valuation law which is trying to develop procedures for valuation involving cash flow analysis has talked a lot about refining the mandatory securities valuation reserve (MSVR) to make it work a bit better or to integrate it; that is, to deal with how one takes into account what the MSVR does when one is evaluating risks under the cash flow analysis. My impression is that the committee members haven't quite wrestled that to the ground and that their report will have some suggestions for how things might be worked on in the future but will not really have that as an integral part of their recommendations. I think it does indicate a general awareness of the shortcomings of the MSVR and growing enthusiasm for developing a more refined MSVR, with more refined reflection of rating categories.

MR. SMITH: Now let's address the question as a group. The question to the floor is will companies attempt to shift more investment risk to the policyholder? This is almost a 60% to 40% split in favor, i.e. 60% more shift, 40% same or less risk shift.

The second question deals with risk selection. Companies operating in countries outside of the United States are allowed to minimize the additional mortality risk associated with acquired immune deficiency syndrome (AIDS) by doing such things as underwriting based upon sexual preference and introducing exclusions in their policies for claims resulting from AIDS. At the other extreme, companies operating within the United States initially had a difficult time convincing some state regulators of their need to test for the presence of the AIDS antibody. As the number of AIDS-related deaths increase, will the regulation surrounding risk selection become more pronounced or less stringent? Will risk selection based upon sex continue or will this be considered unlawfully discriminatory? Is risk selection based upon age in danger from a regulatory/legal standpoint? What products would result if each of these were no longer allowed?

MR. GODFREY PERROTT: I want to concentrate mostly on the last point, that is, what will the effect on product development be if each of these are disallowed. It seems to me that there are two basic questions that are implied by this. Is Canada or the United States or North America a closed economic system? (Regulation that limits selection processes is only effective in a closed system.) In a closed economic system, what level of premium will people pay for insurance and what premium level makes it so uneconomic that it can't be sold?

We all tend to assume that our country, or at least the continent, is a closed system and whatever the regulators do will work. If we look for a minute at the investment area, I would submit that is now very close to a global village; there is significant concern in several countries that they can regulate business to a different exchange. If the regulations get too tight in New York, the business will go to Tokyo or London. If it's not a global village, why do I find out at breakfast what happened to the Japanese market today, how the United States long bond is currently trading in London, and how United States takeover stocks are trading in London? If you let your imagination flow with the global village, will regulation in the United States or Canada take us to the point that we have offshore mail order insurance but insurance that is much more similar to agent-written insurance as opposed to mass marketed insurance?

I then went on to look at what kind of a premium people would pay for insurance, and I thought it would be interesting to try to find some quick statistics on what the different criteria that we frequently use or have used in underwriting appear to be. This is not a very scientific study. It is based on a quick guess at an insurance portfolio and a present value of expected deaths. But the results were quite interesting. I assumed an overweight to standard weight mortality ratio of 1.2, a black to white ratio of 1.3, a male to female ratio of 1.6, a population to insured (the effect of all of our underwriting) ratio of 1.8, smoker to nonsmoker ratio of 2.1, and a blood pressure moderately elevated but at a treatable level to desireable level ratio of 2.2. I tried without any success to find some statistics on lifestyles or income levels. One of the questions is what if we can no longer underwrite the age. On an insurable basis, age 25 versus age 55 is 10 to 1. Working very quickly with Cowell's report, HIV positive is more like 15 or 20 to 1 on a present value basis.

I believe that we probably could design products in a closed environment that would handle ratios up to 2 to 1. (For a long time we didn't differentiate smoker and nonsmoker.) I don't believe we could design products that would handle ratios of 10 to 1 or more. Inevitably the favorable end of the market will disappear, and the cost spiral will drive it into the ground. I also think no matter what regulation is applied, there are probably ways to get around it. For example, after talking to

one or two attorneys, I don't believe there's any regulation today that prevents you from forming private clubs limited to men, women, people under 40, or people who can demonstrate that they test negative on an AIDS test, as long as you don't ask for any tax exemption. It would seem that someone is going to start putting fraternals together that would accomplish insurance selection by that kind of a vehicle.

In terms of product design under these extreme ratios, there's not very much we could do. If AIDS testing were outlawed, we might see a re-emergence of lien-type policies. Someone might design a so-called insurance plan that's really a deferred annuity for ten years. Someone suggested, but I don't think this really works, that you could write AIDS if we had a coordination of benefits (COB) provision in life insurance. If we argue that an insurable risk is some factor of annual income, you could do a retroactive COB so that all companies that insured someone didn't pay out more than "x" percent of their last year's tax return. That seems a little cumbersome.

MR. PALMER: I'm going to talk on a near term micro level dealing with the things that might affect our ability to exercise risk selection with respect to AIDS.

Reviewing the current state of affairs, states seem to be moving more or less into line. For example, California and the District of Columbia seem to moving back toward the mainstream, even though there are substantial variations from state to state with respect to disclosure requirements, confidentiality requirements, counseling requirements, and so forth. Nonetheless there are still serious threats present, and proposals still surface reviving the possibility of a future unacceptable regulatory environment in some states, for example the revival of the Massachusetts initiative. Although current regulatory trends seem relatively favorable, the industry will be continuously at risk of adverse legislation or regulation, and will need to be prepared to fight at the state level.

There are some other future developments which could well affect our success and our ability to retain our current risk selection practices with respect to AIDS. One is the course of the AIDS epidemic. The industry's success to date might well be because the segments of the population affected by AIDS so far have been quite limited, and those affected segments have a limited political clout; so far, the primary groups involved have been hemophiliacs, homosexuals, and IV drug users.

Spread of AIDS to the heterosexual population, aside from its financial consequences for insurers, could greatly increase the political base of our opponents on the risk selection issue. For this to occur, the epidemic need not actually spread very far into the heterosexual community, but just far enough to create a widespread sense of threat among the population at large.

How the epidemic is eventually controlled could also affect risk selection. If the epidemic continues to be limited largely to homosexual and IV drug user populations, with control of the spread through education, this could lead to a significant reduction in the industry's expected excess mortality. This, in turn, could lead to a general perception by the public that the magnitude of the AIDS problem is not a serious threat to an insurance company's solvency, and hence could be supportable by the industry. If the industry's solvency threat diminishes, then those financially responsible regulators who have been supporting us on this selection issue may weaken their resolve.

If AIDS turns out to be treatable in some fashion so as to produce a very significant prolongation of life, then several results may occur. On the good side, the degeneration of AIDS to a disease much more like any other disease means that an attack on risk classification with respect to AIDS would be more clearly a direct attack on risk classification generally, with less special social group overtones when it comes to the political lobbying front. On the bad side, control of the AIDS disease may cause the public and the regulators to force us to accept risks on rating bases more favorable than appropriate (or more favorable than we think are appropriate). If vaccines are developed, then the problem will largely be capped, and hence, may then be viewed as constituting a manageable social burden for insurance companies to bear.

Changes in valuation approaches to reflect the cost of AIDS risks may also have an impact. These could help by quantifying clearly and explicitly the extra costs which insurance companies must pay by way of setting up extra reserves, hence making it clear that there is a real measurable cost

being shifted to insurers. This should help deter regulators from inequitably forcing on us a well-defined extra financial burden.

The way in which insurers respond to the growing AIDS costs in terms of premium increases on in-force business can attract attention to the risk selection process also. Assuming that extra AIDS costs increase to the point where insurers are forced to raise prices where possible through dividend action or increase of indeterminate premium rates or charges on in-force business, a favorable result might occur since a clear price will have been put on this extra risk. On the other hand, this could hurt us by provoking from the general public and the regulators a negative reaction, preventing us from making such price increases and generally leading to the belief that the AIDS cost is a cost that the insurance companies should legitimately bear.

Overall, our ability to select risks in an intelligent fashion will remain continually at risk. We live in a society in which the word "discrimination" has pejorative connotations, but discrimination is the basis of our business. Creative approaches, such as advancing a large portion of the death benefit to insureds with AIDS, will go a long way to preserving our right to fairly and intelligently discriminate.

MR. MICHAEL B. MCGUINNESS: I wanted to take issue with some of the remarks and in particular to point out that in Canada, we already have to set up additional reserves for AIDS. The regulators so far are on our side. For last year-end, they had to be set up as an appropriation of surplus. The word we have for 1989 year-end is that any federally licensed company has to be included in the statutory reserves. What happens with the tax reserves is another story and we're worried about that one.

MR. SMITH: If there are no other comments or questions, then let's address the question as a group. The question before us is will the regulation surrounding risk selection become more pronounced or less stringent? The consensus is that regulation will become more pronounced (80%) with only 20% believing that regulation will become less stringent.

The next question deals with sales compensation. Will sales compensation increase or decrease in the future? Will commissions become level? What will be the driving force for such movement? The barriers between commercial banks, savings and loans, stockbrokers, and life insurance companies are crumbling. What will happen to the marketplace if they are completely eliminated?

MR. PERROTT: It's best to break insurance into its two component parts: protection and investment when looking at commissions. Protection or term would probably have similar commissions to other protection such as property and casualty personal lines. Currently those commissions are about 15 to 20% and level but they're under pressure. Current term commissions typically have a similar present value but are much more front-ended. There's no reason they can't continue to be front-ended, but I expect them to be under pressure just like property and casualty. Investment commission rates will come under much more pressure because they are much higher than comparable sales costs in other vehicles. Banks pay almost no commissions on CDs. In insurance terms, they are so small as to be invisible. Brokerage and mutual fund commissions have decreased. Asset-based sales compensation is probably going to increase. The obvious competitive example of this is the "no-load" mutual fund. All of the sales charge to the user has been transferred to an asset base.

We're going to continue to see pressure from the heavy-hitter agencies and agents to make commissions level primarily because they're convinced that their persistency is better than the average. It's not unlikely once they have managed to do this they're going to turn around and find ways to secure the renewal commissions so they can pull the money out at the front end. Some companies are setting up general agency structures where different commission patterns occur at different levels. In other words, the general agent has the authority to divide the commission almost like different branches, paying a high front-end to the writing agent and holding on to the renewals.

MR. DOLL: The question is will sales compensation increase or decrease? I guess I'd have to rephrase the question. Sales compensation to whom? I think sales compensation to traditional career agents is not going to decrease. It will probably stay where it is. But sales compensation through alternative distribution systems may well be less than through the traditional agency system.

Maybe we should first note that sales compensation in the traditional system has already decreased from what it was. On universal life, the target premiums are generally lower than what non-par whole life premiums were ten years ago. And on par whole life, we have the "comp life" type products where the agent, if he's lucky, can sell all whole life but may end up selling something that has a mixture of term insurance and paid-up addition riders that lowers his overall commission.

It's interesting that when universal life first came out, the first few products had commissions on them that were roughly half of traditional products. The logic was that the agent would be twice as productive selling this more saleable product and that everything would work out fine. But, as it worked out, the commissions on universal life products gradually rose up to the same percentage level as on traditional products. And now we have in the last few years seen a trend away from flexible premium universal life with its low commissionable premiums to fixed premium universal life or excess interest whole life or interest sensitive whole life (whatever you want to call it) where the commissionable premiums are back up to the levels of what they were several years ago.

I believe that we will not see a decrease in sales compensation on the "bread and butter" business sold through traditional distribution systems beyond what we have today. The system is expensive and unless we find ways to make the field force much more productive (and that seems to be the Holy Grail), there is little to indicate that the compensation can be significantly less and have that field force survive. However, I do believe that the traditional distribution system will shrink in relative magnitude to the overall distribution of life insurance. I know that's been predicted for a number of years, but it seems like universal life and the internal replacements that it generated just delayed that process by a few years.

Since I'm from Florida, I'll have to note that Florida overturned its anti-rebate statute about a year ago, and to the best of my knowledge, only one agent has taken advantage of the fact that he can rebate in Florida now. There hasn't been any kind of trend in Florida among agents trying to cut their compensation in order to increase sales.

I'd like to make a couple of comments regarding the comparison of term insurance with property and casualty insurance. There are a couple of differences with life insurance and property and casualty insurance. We need to keep these in mind. One is the fact that underwriting allows us to get select and ultimate mortality experience. That's different from your traditional casualty where when companies' underwrite my homeowner's insurance or my automobile insurance, my risk this year will be just as high as it will be next year. The fact that we can underwrite and select our risk means that we have some margins available in the early years to cover some higher distribution costs. Also we have the guaranteed renewability feature that should be worth something to the consumer if we make the sales pitch appropriately. After all, if I go out and have a couple of accidents in my car, I'm likely to lose my car insurance, but my life company is going to be stuck with me.

Regarding the investment component of life insurance, I agree with Godfrey that there's going to be more competition from banks, and that's part of what I meant when I said that part of the distribution will be away from traditional distribution systems and through alternative distribution systems. I think the amount of the effect is going to depend upon the type of product and the manner in which it is sold. We have to keep in mind that banks, stockbrokers and investment companies will probably be focusing on single premium products. That's what they do very well. I don't know if they're set up necessarily for selling annual premium business or business that depends upon renewal premiums.

Also, the loads on the products are going to depend on whether salesmen are involved. You can talk about the no-load mutual funds, but there are also loaded mutual funds out there. They are being sold. The people who sell these mutual funds are getting sales compensation for it.

How many people here before the 1986 tax act bought any kind of limited partnership tax shelters, say real estate or equipment leasing? If you have ever read the prospectuses on those things and saw how much of your contribution was going towards distribution costs, you'd find that it didn't compare very favorably to single premium life. The fact that there was a tax shelter there allowed people to sell products that had very high distribution costs. The banks, however, can compete fairly well in some areas when they're not paying salesmen to go out and make the sale, for example, IRAs in the United States. The banks did seem to get the lion's share of that

business although the life insurance industry did get some. I understand that in Canada where they have the registered savings plans, when that first came out, the insurance industry did get a significant portion of that business but the banks are making inroads on that right now.

I think competition from non-life companies will not lower the compensation for a given sales situation but will shift the market share away from salesmen somewhat into alternative distribution systems. But I think there will always be a place for the traditional distribution system and the traditional sales compensation.

Regarding making the commissions level, I don't see that much with salesmen. It's not consistent with the sales effort. If the salesman's primary objective is to sell, I think we're going to have front-ended commissions. I know there are problems with front-end commissions, namely the capital drain and the persistency risk. If we view the front-ending as strictly a financing arrangement then, like Godfrey said, if we have level commissions the agent will probably find some other way of doing the financing. Financing will be by outsiders or maybe the agent will assume some of it himself. But the insurance company may find that the rate of return from this financing is attractive and then go back to financing it itself.

Level commissions are becoming somewhat popular in Canada. Talking to Charlie Brown at Great West Life yesterday, he said that they're doing it with a three-year financing for a brand new agent to get him up to speed and they're quite happy with it and they think it will work. But I think it will only work in situations where the company is going to treat the agent more like an employee and less like a salesman. I might mention that anybody who's interested in level commissions ought to take a hard look at what the home service industry has done. For a large number of years, its sales compensation traditionally has been less front-ended than the traditional career agent from the non-home service companies. There was a large level percentage of premium component, and the agent's first year commission, to a large extent, was based upon the increase in premium on his debit. So he was penalized just as much for a lapse as he got credit for a new sale. Anybody who's interested in level commissions ought to talk to some people in the home service industry to find out how well that works. I think level commissions could work for closely held career companies or companies where the agents are closely held but probably won't work for companies dealing with independent agents.

Regarding the persistency risk, we're addressing that somewhat in the product design now with things like persistency bonuses and bigger surrender charges. I think there will be some continued shift to agents. We've seen some of it with agent-owned reinsurance companies. It will probably be a mixture of shifting to agents and shifting to policyholders.

MR. SMITH: Are there any additional comments on the levels of sales compensation that we'll see in the future?

MR. ROBERT A. WILLIS: The province of Quebec is on the verge of legislating level commissions presumably to protect the consumer and I think where they're coming from is that there have been a lot of complaints about a lot of replacement practices in Quebec. They see this as preventing that and therefore protecting the consumer. I wonder if any of the panelists would care to comment on the possibility of a similar thing happening in individual states in the U.S.?

MR. DOLL: I don't believe that we'll see, in the U.S. legislation requiring level commissions, but I would not be surprised if a proposal was made to disclose commissions. And if the commissions are disclosed to the consumer, that might go a long ways towards level commissions.

MR. PERROTT: I think disclosure is more likely than leveling regulation. The other possibility from a consumer protection point of view would be legislation similar to that in the U.K. where an independent agent is obligated to look for every possible product that is in the best interest of the client and to document that he did that. He can either be independent in which case he has that obligation or he can only sell for one company. Whichever status he has must be disclosed.

MR. SMITH: Okay, let's take a straw poll. Will sales compensation increase or decrease in the future? Overwhelmingly, the consensus is that it will stay the same or decrease (100%).

The next question has to do with rate regulation of life insurance. The Technical and Miscellaneous Revenue Act (TAMRA), the Deficit Reduction Act of 1984 (DEFRA) and valuation and

nonforfeiture regulation have effectively set limits on the amount of premium that can be charged for life insurance products. Will this type of rate regulation for life insurance products become more prevalent in the future?

MR. PALMER: In going through these issues, some of these effects involved are largely secondary kinds of effects on pricing, not primary in the sense of a mandated rate that can be charged. But there are an emerging number of influences which have the effect of constraining one's ability to charge a rate, either a floor constraint or an upper constraint.

I want to talk first about influences from the tax environment: TAMRA, DEFRA and related regulations. It seems pretty clear that we're going to see a continued erosion (that is, a tightening) of controls on the prices we can charge until and unless the need to define life insurance is removed by providing a tax on the entire inside buildup, so that what's life insurance won't matter anymore. More specifically, controls on mortality charges which were added by TAMRA in 1988 will be further defined and refined by regulation. These will have to address the permitted spread (for tax purposes) between current charges and guaranteed charges, appropriate reflection of substandard risks in mortality charges used to compute limits, appropriate use of unisex mortality, appropriate use of smoker distinct mortality tables, and appropriate reflection of guaranteed issue and other limited underwriting mortality.

The regulations will also have to deal with expenses, and what is a "reasonable" expense for purposes of tax computations. Definitions of company experience, industry experience, the relation between current levels of expense charges and guaranteed levels of expense charges, are all issues which will have to be dealt with by the IRS in promulgating regulations.

In addition, the interplay of mortality and expense charges with other pricing parameters, most notably interest, will also have to be examined by the regulators. Although the tax law deals explicitly with mortality and expense, the regulators have recognized the possibility of distorting mortality and expense charges with an offsetting distortion in other factors such as interest to produce results advantageous to us in establishing high limits. This is possible both in bundled products, including par policies by use of the dividend mechanism, and in unbundled products. The regulators will recognize the need to examine the realism of all elements of pricing. The prospect of having the IRS review dividend formulas or pricing demonstrations for reasonableness is not a particularly attractive one.

Our current favored tax treatment is predicated largely on the social importance of life insurance in the fabric of American life. If, as suggested earlier, the risk of death recedes in perceived importance, so will the continued justification for our tax advantage. For a sobering look at some of the tax policy arguments for eliminating this advantage (that is, tax deferral on inside buildup), I refer you to a recent article by Andy Pike in *Tax Law Review* titled "Reflections on the Meaning of Life." Andy obliquely puts forth a Swiftian "modest proposal": that if Congress would eliminate the cost of the tax deferral of inside buildup but preserve the alleged social purposes of cash value life insurance by paying the term cost for all permanent life insurance currently in force, it could save a considerable amount of money.

There are, of course, arguments for the social purpose of cash value life insurance as a savings vehicle. But life insurance as savings is treated more favorably than deferred annuities, and both are treated in some respects more favorably than other tax-advantaged savings vehicles such as pension plans, 401(k) plans, and IRAs, in that there is no upper limit on the amount of savings which receives favorable treatment under our products. Our opponents would argue then that the rich receive the greatest advantage, and the poor get no advantage since they can afford only term insurance.

The results of this line of thought can only be continued erosion of and possibly complete loss of the tax advantages of our traditional life and annuity products.

Changes in the valuation laws are much more likely to set lower, not upper, bounds on premiums that can be charged.

Near term valuation influences on premium rates might arise on a number of fronts. One is AIDS reserving, about which we heard a little at this meeting, and about which we'll hear much more

when the Society's groups issue their reports in the next month or so and when the Actuarial Standards Board issues its standards.

There is a proposal called Actuarial Guideline XXX, which will force up premiums on term-like increasing premium whole life policies which have significant guarantees or, more likely, eliminate these products.

Cash flow analysis requirements under the valuation actuary approach should force better quantification of the risks we're taking and encourage price increases for risks which are now inadequately priced. Coupled with this, modifications in the MSVR to more accurately reflect asset quality may also have some impact.

There are more direct possibilities of setting upper bounds such as the current attempt by the State of Washington to set a maximum on premium rates. This is a regulation which would require that premiums accumulated at a specified interest rate not exceed the face amount of a life policy. This was designed to limit premiums on highly priced burial insurance, but it would also limit normal products at older ages and for substandard risks.

Another legislative proposal that may have some longer term effect on our pricing latitude is the discussion of changes to McCarran-Ferguson. As you know, proposals to repeal or limit severely our current limited exemptions from Federal law under McCarran-Ferguson are introduced annually by Senator Metzenbaum. Such action would generally open the door to massive federal intervention in our business. While these proposals I think are directed largely at property and casualty and directed at removing direct property and casualty rate setting at the state level, it would create potential rate setting problems for us at the federal level.

The likeliest attack on life insurance would probably come through oversight on our activities by the Federal Trade Commission (FTC). This could include studies, reports to Congress on the true price of life insurance, truth in advertising requirements, disclosure of commissions and other consumer disclosure requirements, and similar techniques. Those of you who remember the FTC study of several years ago will know what to expect.

Additionally, pricing effects could result if our ability to pool data relevant to pricing is limited. It is generally believed that we would ultimately keep the right to pool statistical data but not pricing data. It's difficult to know how this will come out when prices are based largely on statistics.

Another possible kind of attack is Proposition 103-type state legislation. This would create nearly unbounded potential for mischief. Any consumer dissatisfaction with any aspect of life insurance operations could lead to irrationally mandated premium controls or controls on any other aspect of our business.

There are many recently emerged new threats which would reduce our prerogative to set our prices. None of them appears to be directed towards increasing our ability to design and price our products. Most of these influences will tend to lead towards price increases: AIDS, valuation actuary reserving, increased tax burdens on our in-force business (not only at the Federal level, but also at the state level, such as the supplemental premium tax proposals in Florida). All these, and any other factors which force our prices up, will greatly increase our chances for more public scrutiny and interference in our ability to set prices.

MR. DOLL: I really find very little to disagree with John about. I might on one minor thing. He mentioned several influences that will tend to raise the price of insurance and maybe cause more public scrutiny of the rate setting process. But I believe that more important than those elements will be the interest rate that we credit to the policies, and over that, we have little control, at least with regard to the level of interest rates that we can earn. We do have a lot of control over how we disclose that. I think, due to the illustration wars that we're seeing now, we'll probably see increased regulation of that aspect in the future, perhaps even so far as what's required now on dividends being extended to nonguaranteed elements.

John mentioned the issue of whether life insurance is socially important and predicted that we're losing that battle and therefore we'll have an erosion of our tax advantage. I would like to think that we will win at least part of that battle and that we can continue to maintain an image of life

insurance as being socially important. However, the flip side of that is, if it is socially important, we will see a continuation of regulation in other areas with regards to life insurance. We can't have it both ways. If it is socially important, then we're going to have regulation of the many aspects of life insurance. If it's not socially important, then we'll lose the tax advantages. We don't want to lose the tax advantages, so we're going to continue the argument that it's socially important. By the way, there's no rate regulation of term insurance, John. I guess that means term insurance is not socially important.

Rather than try to find areas of disagreement with John so far as the tax area is concerned, I'd like to talk on a somewhat different topic that John left for me, that is, the part of the question that dealt with nonforfeiture regulation. At this meeting in Vancouver is a session that deals with the proposed changes to the standard nonforfeiture law. Any of you who have an interest in what the nonforfeiture requirements of products will be in the future, I urge you to attend this meeting. The committee that's working on this is scheduled to make a report shortly after this, and this may be your last opportunity to give input on at least the draft of the committee report. Interestingly, even though the committee has been meeting for two years now, there still are some very large issues about which the committee has not decided which way to go. Any strong comments or well-reasoned comments may impact the future of nonforfeiture legislation.

Let me give a brief background on what this committee has done. It was set up as a Society of Actuaries committee early in 1987 to investigate the principles of nonforfeiture with regards to equity, in light of the new products that had come out, for example, universal life. We came out with an interim report last fall in which we discussed some of the principles of nonforfeiture. We basically said that there are no particular actuarial reasons to require nonforfeiture values but given the historical and regulatory context of U.S. life insurance industry, we thought nonforfeiture benefits should continue to be mandated.

We went on from there and said that, given we have mandated nonforfeiture values, we can discuss various actuarial equity values, and we did. The equity value we settled on was the asset share value which is the same value that underlies the current standard nonforfeiture law. We just confirmed what the Guertin Committee in 1941 and the Unruh Committee in 1975 concluded. However, there is still the issue of how to determine this minimum nonforfeiture value. There has been a fair amount of sentiment towards changing the current nonforfeiture methodology to a retrospective approach. The retrospective approach says minimum values are the premiums less certain loadings minus certain mortality charges accumulated at a certain interest rate. The problem with that kind of formula is it is very easy to manipulate the results you can get unless you start becoming fairly rigid on what those components are: the mortality, the expense loads and the interest rate. But then once we start saying we're going to put restrictions on what the components are, you come perilously close to rate regulation, in fact you might go all the way. One of the viewpoints on our committee is that perhaps we ought to accept the inevitable, the inevitable seeming to be rate regulation on life insurance as we've gotten now in TAMRA. Instead of following the parade maybe we should lead the parade and just go ahead and suggest certain restrictions on expense loadings and life insurance policies.

Another issue that the nonforfeiture committee is wrestling with is whether or not we ought to require cash values in addition to paid up values as nonforfeiture minimums. Allowing a no cash value whole life policy is a distinct possibility at this point in time. The other broad issue that we're discussing is what to do about nonguaranteed elements. Should there be some limits on persistency bonuses? That's one area right now where there seems to be little regulatory restrictions but that may not last forever. If you're interested in how the future regulation of that may evolve, you might also be interested in what this committee is up to.

MR. WALTER N. MILLER: The proposed Washington regulation that John Palmer mentioned may be closer than you think. It will set an absolutely horrendous precedent if it is allowed to be enacted. It is a classic example of regulators using a hammer to kill a flea. There is a hearing today on the court case that has been brought by the ACLI plus a number of individual companies including my own. So the outcome is probably going to be known before too much time passes. It's a really interesting regulation. Via the accumulation technique that John mentioned, it in effect puts a limit of $75 and change, I think it is, per thousand on any and all premiums for life insurance including special class extra premiums, including premiums for supplementary disability and accidental death benefits and so on. At this point, all we can do is send out some extrasensory perception waves and hope that our lawyers do a good job in that hearing today.

One other comment on another area where it seems to me that legislative rate regulation is with us is the whole unisex area. It would seem to me quite apart from the limiting effect on variation in rates to reflect risk factors. Wouldn't it be true that a mass move towards unisex pricing would push the level of pricing upward because it imposes on companies an additional risk, namely the risk that the mix that you assume for your unisex rates is going to turn out to be wrong?

MR. PALMER: I agree with you, Walt. You're exactly right. You're taking a mix risk which has got to cost you something unless you've got a surefire way to manage it as by Godfrey's technique of developing lots of little fraternal organizations.

The Washington regulation is a serious problem. Various commentators, when it first surfaced, registered their objections with actuarially reasoned arguments, all of which fell on completely deaf ears. The progress of this proposal seems to have very little to do with what we would view as rational arguments and has much more to do with politics. The challenge to it may depend on whether or not the Washington Department, in fact, possesses the authority to set rates, not whether it's an actuarially sound idea.

I'd like to comment on a couple of other things that Doug mentioned by way of expansion. There are some additional disclosure regulatory activities taking place that you probably need to be aware of. One is the so-called yield index which has been around for a long time, and I think the NAIC will finally adopt a model yield index regulation in June or sometime later this year. This would require the calculation of something that looks a lot like an interest rate which is supposed to be an index of the cost of the product. In spite of efforts by people to demonstrate that the sorting out of products done by this yield index gives you no new information in comparison with what current indexes give, some regulators want to proceed with this anyway. I think it is being put out more as an alternative that people can use if they want to. But all you have to have is one significant state pick it up, and you've got to start coping with it and programming to do it. So it really is a troublesome regulation.

Another regulation that's floating around is a fairly onerous set of requirements for universal life policy disclosure. There's a multi-page form that gives cash value demonstrations and all kinds of questions designed to clarify the sales illustrations. This is on a very fast track, apparently motivated by the political ambitions of the regulator who's pushing it, and it seems nearly unstoppable. There have been ACLI general bulletins describing this, and it's something you need to be aware of as well.

MR. SMITH: It's interesting to note that one of the by-products that was thought to occur with TAMRA was the elimination of the modified death benefit products that we've seen offered through direct response on a guaranteed issue basis, a lot of times through celebrity endorsements, because they violate the seven-pay test. The reality is that these companies (and these are probably the least competitive products that the industry offers) that offer these have come to the realization that TAMRA doesn't affect their product because there was no way that the policyholder could ever surrender his policy and receive a taxable gain. So that the least competitive elements of the industry were the least affected by this apparent rate regulation.

Let's take a straw poll. How many believe that rate regulation for life insurance products will become more prevalent in the future? The answer is 100% of the audience.

Our next question is what type of products will we sell if the favorable tax treatment of life insurance is eliminated or continued and enhanced?

MR. PERROTT: First, I want to discuss how life insurance is currently favored because I counted three different ways; frequently when we talk about the tax-favored status we focus upon the inside buildup. The first way it's currently favored is who can sell life insurance is limited. This protection is the most likely to end because the banks and the brokerage houses over time are going to win. The second way that it is favored is the tax-sheltered inside buildup, and it's important to remember this is not just the tax shelter on the buildup but also the deductibility of the cost of insurance. Implicitly both of those are rolled into that and either one could disappear. It can go one of two ways. If Representative Rostenkowski has his way, it will be eliminated by regulation. An alternative that John alluded to earlier is a loosening of the regulation on nondeductible IRAs. This would have the same effect because it would allow our competitors to sell products with a tax-sheltered inside buildup. The third way that insurance is favored is

through the tax treatment at death, and this one appears to be relatively secure. I'm not aware of lobbying to get rid of it.

There are really three different products we sell. We sell protection products which are pure protection. We sell liquidity products which don't protect against the financial effect of death but protect against the cash flow problem of estate taxes. Then we sell investment vehicles. The need for pure protection is not going to change regardless of the tax sheltered or other favored status of life insurance. It's not obvious that any change would happen in that market. The liquidity needs probably don't change but if you strip the tax-favored investment out of liquidity products, you could see more pressure (in spite of the committee that Doug was describing) for noncash value products. If a product really is serving a liquidity need, the Canadian term to 100 style product is significantly cheaper.

Lastly, we spend a lot of time in doom and gloom about what a terrible world it will be if we lose the inside buildup. I submit that fairly quickly we would adjust to that. By and large, the insurance companies have strong investment departments. They know how to invest and make money at least as well on average as any of the other hot-shot managers. We have a strong distribution system. If we lose the inside buildup, products will change. We may sell more annuities than we do life insurance because the attraction of products such as single premium whole life would disappear. But we will continue to sell products and they will not be a lot different. We also might see much more tontine kind of products. For example if the inside buildup is taxable, you might see deferred annuities where there is a 4% guaranteed rate and there is some very substantial deferred benefit. This would be structured so that it's only a huge persistency bonus with all of the excess of the declared rate over the guaranteed rate rolled into it. You could also take that product and pay out a portion of the taxable increase so that there wasn't a tax drain.

As to what will happen to life insurance products if the tax-favored status is enhanced, the answer is fairly obvious. We would see more investment vehicles. We would probably see a return to endowment type policies. We might see some other things that are common in other countries such as financing home purchase through an interest only balloon mortgage coupled with an endowment policy.

MR. DOLL: We like to talk gloom and doom about losing the inside buildup, but it seems that we've forgotten that, prior to 1984, we actually had a proxy tax on the inside buildup. There was a tax on investment income, and we survived reasonably well until the formula in the 1959 tax act got way out of wack. But since 1984, this is the most favorable tax situation that life insurance has had on investment-oriented products since the 1920s. Although we talk about how bad things are going to be if we end up paying tax on the inside buildup, depending upon what kind of tax on the inside buildup we get, we may find that we're able to cope. I understand that in Canada there's going to be a proxy tax on investment income on policies of 15%. It was explained to me, and it's a very complicated formula; they're still trying to work it out. When we talk about tax on inside buildup, we may come full circle and come back to something like that.

What would happen if the inside buildup did go away? I don't think there would be much effect on the lower income market for life insurance. In the Southeast, a number of home service companies sell products people aren't buying as investments. Otherwise, I guess we could see a significant effect. Jim Anderson has said in a number of speeches that he's estimated that the effect of the inside buildup combined with the tax-free death benefit is worth something like 10 to 15% of premium to the life insurance industries versus other industries. Of course, that varies by age and type of plan. He used to use the number of 15% but when the personal tax rates got cut under Reagan, he now says 10 to 15%. That's pretty significant. If we lose that tax advantage, perhaps we could look at that as being the kind of amount that we would have to trim from our home office expense and our distribution expense to be able to continue to compete. Otherwise, I generally agree with Godfrey. We'd go more for annuities, sell more term insurance, fewer cash value style products, more health and long-term-care products.

I also agree with Godfrey that it's difficult to contemplate enhanced tax treatment for any kind of product. If we did get it, it would probably not be the kind of product that could only be sold by life insurance companies. It would probably be something like we saw several years ago with the IRAs where the life insurance industry and the banks would be on equal footing and we could

scramble to get a part of that, but we would have no innate advantage over the other financial institutions.

MR. PALMER: I think one area where there is a possibility for some clarification of, or possible improvement of, tax treatment for our products is long term care. That is a growing social need, somewhat offsetting life insurance as a diminishing social need. I think the tax status of long term care is somewhat unclear at the moment, and we can at least expect clarification and possibly favorable clarification in the next year or two.

A second comment relates to the loss of inside buildup. When we talk about the loss of inside buildup, we generally have visions of having millions of 1099s sent out to our policyholders across the country. I think that perhaps a more likely scenario for loss of inside buildup is a proxy tax. The government would certainly be a lot happier trying to collect a given amount of tax from 1,850 insurance companies rather than 150 million Americans. I think that would be far more politically attractive. After all, the inside buildup shelter is a problem only because you've got both no tax at the policyholder level on the income growth in the policy and no tax at the company level because the increase in reserves on account of interest is tax deferred. The double deferral is what the problem is, and you can attack that by dealing with the deferral either in the policyholder's hands or in the company's hands. The government, in fact, had a reasonably well developed proposal called QRA that was directed at property and casualty companies and did just this. It was designed to be able to fine tune the degree of proxy tax you want to inflict. It's a slightly regressive way of doing it because it involves assuming an average policyholder tax rate and not everybody is average. The low bracket people will basically pay the same proxy tax as the high bracket people. A proxy tax approach will make it more difficult in the marketplace simply because the tax will be implicit in the sales illustration because it has to be built into the price by the company. With a 1099 version of tax on inside buildup, you can still show the same price and just not talk much about the tax consequences. The illustrated numbers would look about the same. It would only be different when the policyholder came to pay his tax. So I think you need to keep this possibility in mind. That is, what form loss of inside buildup might take can make a fairly substantial difference in how painful it might be to us.

MR. PERROTT: One thing to bear in mind while you're thinking about John's proxy tax is that it's likely that Doug's home service companies and Brad's mail order companies might have a bias towards direct inside buildup tax.

MR. SMITH: Okay. Let's take a straw poll. How many people believe that the favorable tax treatment afforded life insurance policies today will continue in the foreseeable future? How many believe that this will diminish? It's a 50%-50% split.

The sixth question has to do with taxation and reporting of taxation. The 1990 Alternative Minimum Tax (AMT) change (requiring 75% of the increase in deferred acquisition cost (DAC) to be included in Alternative Minimum Taxable Income (AMTI) is a step towards taxation of insurance companies on GAAP earnings. What effect will full implementation of that have on insurance products? Additionally, for Godfrey, how will the accounting standards that dictate how we report taxes on a GAAP basis vis a vis Financial Accounting Standard No. 96 affect the products we offer?

MR. PALMER: So long as the adverse treatment of deferred acquisition cost in the tax base is limited to the AMT, this will only raise costs (and perhaps prices) slightly for those companies that are affected by the AMT. The AMT currently takes account of this indirectly through the book income adjustment but only at 50% and under the current rules it constitutes primarily a prepayment of the regular tax. That's because the AMT is carried forward as a credit against the regular tax since it's treated as a reversing item. I've got to admit to a factual lapse here since I don't really know how DAC under the new version (the 1990 forward version) is treated. When I read the law, it looks as though the reversing principle still applies. That is, an AMT adjustment item develops a credit so long as it's a reversing item and does not develop a credit if it's a nonreversing item, such as tax-exempt interest. In my naive actuarial view, DAC is a reversing item. Generally, the period of prepayment would be relatively brief; hence, the extra costs generated would be relatively small.

The effect of putting DAC in the AMT base would be most pronounced for (a) fast growing companies where the difference between taxable income and GAAP income is large due to the

presence of deferrable acquisition costs and (b) companies that find themselves under the AMT for other reasons. Here again the key is, so long as we're talking about a credit carryforward, the amount of time spent on the alternative minimum tax base and the consequent length of the prepayment of the regular tax.

If the principle of reflecting DAC is extended to the regular tax base (and some believe this to be inevitable), then reflecting DAC will permanently increase costs especially for fast growing companies. I think it is likely that government tax policy people believe that this would constitute the correct treatment of DAC. It will create significant pressure to increase prices and will tend to limit the growth potential for some companies (especially those reaching growth limits imposed by capital already). It may be of interest that the U.K. life company tax law has been changed to require spreading of acquisition costs on a linear one seventh per year basis starting in 1990.

In addition, adding amortization of DAC to the regular tax base would also probably provoke a search among insurance companies for reinsurance solutions, the most convenient loophole for any tax problem. An example might be the securitization or sale of DAC. The tax effects of the sale of DAC and possible involvement of Section 845 recharacterizations are currently unknown (as are many other effects), but if substantial tax can be avoided in this fashion, the government may be expected to react.

The increase in company cost by reflecting DAC in the tax base will create pressure to reduce acquisition costs, or at least deferrable acquisition costs, for example by leveling commissions and/or increasing front-end loads. Such treatment of DAC would exacerbate the life industry's problems vis-a-vis banks in an increasingly deregulated world, especially if we lose tax-free inside buildup, by adding to our already high distribution costs.

Depending on how clearly defined DAC is in tax law, such a change may bring in the accounting profession as IRS partners in determining our taxable income in much the same way that the NAIC became unwilling partners as a result of DEFRA.

Additionally, companies which are not otherwise required to prepare GAAP statements (mutuals and nonpublic stocks) may have a significant advantage. They can use the latitude in defining DAC which will inevitably be present to minimize the tax effect on them.

The industry is attempting to moderate the DAC adjustment by arguing that some DAC amortization is already present in the calculation of taxable income due to the use of preliminary term reserve methods. It is not clear how successful this will be.

The ultimate effect then will be a mix of pressures to increase premiums to cover the extra costs, and attempts to decrease costs generated by marketplace forces. Companies will be forced to moderate their internal growth patterns, and the attractiveness of growing by acquisition may well increase.

MR. PERROTT: Like Doug, this is a situation where I find very little John said to disagree with. If the increase in DAC will be a reversible item for AMTI, hopefully the promised regulations which might appear before the change becomes effective in 1990 will address that. As you probably know, there currently are no regulations, and there is a nebulous promise that there will be some.

I think the interesting implication if the tax base does become GAAP income (and I think that is the ultimate position the IRS will take) is going to be the dichotomy between the publicly traded stocks and the other companies. I was talking to a colleague who works primarily with mutual companies and his reaction was that obviously, management would try to defer GAAP earnings to maximize the real value of the company because that will defer the payment of tax and increase the assets. I suggested that if he were compensated based on the GAAP earnings of the company he would probably pay the tax. It seems publicly traded companies are going to still try to front-end GAAP earnings because that is by and large what their management is compensated on. The other companies, as John said, will try to defer GAAP earnings.

As far as product design, I agree with everything John said. The other areas that might see more emphasis would be combinations of low or no cash values coupled with persistency bonuses, basically anything that improves the product. As long as the tax rate does not change, I don't

think it will have any effect on our products. When the tax rate goes up by 10% or more, the howls that you'll hear from the publicly traded companies will finally dwarf out the rather obnoxious squabble going on now between the mutuals and the stocks. Each points to the other and yells, "They're robbing us blind. Tax them more." I don't know what it would do to our products.

MR. SMITH: Our last question has to do with the fact that the European Common Market is scheduled to eliminate all internal barriers by the end of 1992. There is concern that they will also raise external barriers. What effects, if any, will this have on the North American life insurance market?

MR. PALMER: I have a couple of observations here not based on a great deal of research. The dropping of the barriers in Europe should increase the opportunities for U.S. companies to spread into Europe on a more economical basis. This is because a market with a common set of regulatory requirements will be created, and the significant costs of coping with a wide variety of regulatory barriers in Europe will be greatly reduced. Of course, individual country social barriers will still exist and may be significant enough to prevent effective widespread penetration. Tastes in insurance coverages, savings habits, and numerous other social idiosyncrasies may well still cause the market to be fragmented.

In some European countries, the insurance business is highly regulated in such a fashion that the industry is dominated by a small number of companies in cartel-like operations. Presumably, the elimination of barriers will break up these cartels or at least cause a period of turmoil during which new cartels are formed.

The newly created opportunities in the European area may well redirect the attention of European investors to Europe's insurance industries and reduce their desire for acquisition activity in North America.

Similarly, the emergence of the Common Market as a single insurance market could well divert the attention of the Japanese (who after all have most of the money) away from North America and towards Europe.

The premise of the question may well be doubted, that is, will all internal barriers in fact really come down in 1992 or any time soon thereafter? Many people have expressed considerable skepticism that 1992 will be a "big bang," and that national jealousies will manage to keep de facto barriers in place for some substantial time.

We have some affiliate operations in Europe as well as Japan and are well acquainted with some of the extra costs of coping with foreign regulation and customs. Until recently the U.K. had been a relative sea of tranquility on the regulatory front compared to the U.S. but in the last couple of years, it seems to have caught our regulatory disease. Our people there say this is only once and they'll never do it again, but I remain fairly skeptical of that.

MR. SMITH: In conclusion, the results of our straw poll indicate we're relatively split with approximately 60% of us believing that companies will attempt to shift more of the investment risk to the policyholders. Approximately 80% of us believe that the regulation regarding risk selection will increase. Nobody in this audience believes that sales compensation will increase, with 100% believing that it will either stay the same or decrease. We virtually all believe that rate regulation will become more prevalent, and we're split as to whether the life insurance industry will continue to enjoy its favorable tax treatment.