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CASH VALUE STRUCTURES OF THE FUTURE

Moderator: MICHAEL E. MATEJA
Panelists: JOHN E. MCKAY
WALTER N. MILLER
PHILIP K. POLKINGHORN
ROB T. WORLEY, JR.*
Recorder: PETER C. VAN BEAVER

- The insurance industry is unique in the form of the financial instrument offered to consumers. Products earn long-term interest rates yet generally guarantee cash out without loss of principal.
  - Can the industry survive the long-term offering of such products?
  - What changes, if any, are necessary in nonforfeiture requirements to ensure a viable industry?
  - What is the likely evolution of product structure in the coming years?
  - Market value of insurance contracts

MR. MICHAEL E. MATEJA: We have a well-qualified panel, and I think you'll find that they have some interesting thoughts on the subject at hand.

First, we will hear from Walt Miller from the Prudential. He is, I guess, the retiring Chairperson of the Academy Task Force on Nonforfeiture Values. The recommendations of this Task Force will certainly have some bearing on the structure of cash values in the future.

Next up will be Phil Polkinghorn from Tillinghast. Phil's assignment is to provide a perspective on the U.S. market, and to try and anticipate what may happen in the future as a result of the proposals in the Nonforfeiture Task Force Report.

Then we will hear from John McKay from PPI Financial Group in Canada. John will focus on the Canadian market where they have a very different regulatory environment compared to the U.S. I think you will see that the Canadian approach to cash values is much different from the U.S. approach.

Then, finally, we have a guest, Rob Worley, who is President of Living Benefits in Albuquerque, New Mexico. This is a truly new company established to purchase life insurance policies of the terminally ill. This new company represents an initial step toward a market-value approach to the value of a life insurance policy. His views on this approach will be very interesting, because if this new idea proves successful, it will pave the way towards an entirely new structure of cash values for life insurance policies. Peter Van Beaver from the Mass Mutual will be the recorder of this session.

MR. WALTER N. MILLER: I must start off by saying that a lot of thoughts run through your mind when, first crack out of the box, the moderator refers to you as a retiring chairperson. That can mean many things. In this case, I devoutly hope it means that I am retiring because the Task Force is retiring, having rendered its final report. However, the process of developing whatever is going to be the next wave of nonforfeiture legislation in the U.S. is by no means completed. I'll mention my outlook for what may happen next at the end of these remarks.

My main purpose is to outline and briefly discuss the main points in our report. These are listed in the Executive Summary of the report.

* Mr. Worley, not a member of the Society, is President of Living Benefits, Inc., in Albuquerque, New Mexico.

First, a bit of background. The last time the actuarial profession was asked to take a serious look at the basis for minimum nonforfeiture legislation in the U.S. was in the mid-1970s. At the request of the NAIC, the so-called Unruh Committee was formed. At that time, it was observed that about 30 years had elapsed since the Guertin Legislation had been developed, and that during that 30-year period, there were many changes in product design and in the economic picture. Therefore, it was felt that it was time to take a fresh, forward-going look at nonforfeiture legislation in the light of what had transpired and what the current outlook was. The Unruh Committee did what most commentators thought was an excellent job that led to some significant changes in nonforfeiture legislation which were largely implemented in the late 1970s and early 1980s.

Now, we have an interesting example of the accelerating pace of change. Scarcely more than ten years after the Unruh Committee was formed, the NAIC again said to the actuarial profession: since the last time a professional committee examined the nonforfeiture area, there have been very significant changes on the product scene (the whole wave of nontraditional products) and, in addition, we know that now and looking forward we must learn to live and deal with a much more volatile economy than any of us had previously experienced. So, our committee was formed in the Spring 1987 with a basic purpose and charge essentially the same as that previously given to the Unruh Committee.

We released a preliminary report with a number of tentative conclusions in the Fall 1988 and as I just mentioned, completed our final report a little while ago. Let me now turn to the main conclusions and proposals presented in our report as outlined in the Executive Summary.

Item 1 says our basic premise is that nonforfeiture benefits will continue to be mandated. Some might say, "Well, of course," but we spent some time exploring this basic premise. In the past, it seems to have been a given that as long as there is insurance regulation in the U.S., these benefits as well as minimum levels for them will be mandated. We asked ourselves whether that premise really needs to continue. We concluded that it might not necessarily need to continue if there was an active and reasonably objective secondary market for life insurance policies -- under which a typical policyowner could go to a readily accessible market and get a reasonably fair price for his policy if he wanted to give it up. However, looking around the current scene in the U.S., we don't see that market. I can't stand here and tell you this will never happen, but our committee didn't think there was enough chance of it happening in the foreseeable future to warrant changing the basic premise. I must also say that many of us thought that our committee's chance to have an impact in the real world would be significantly diminished if a basic theme of our report was that nonforfeiture values should be totally deregulated.

Our next major conclusion was that paid-up insurance is a benefit that satisfies nonforfeiture equity. We believe that policies do not necessarily need to provide for cash surrender values as long as they provide paid-up insurance values. There is a school of thought, from which we may hear more, that says we ought to go further and permit policies with neither cash surrender values nor paid-up insurance benefits. This development has already occurred in Canada.

The next point indicates that we agree with prior opinions that the asset share is an appropriate value on which to base minimum nonforfeiture benefits. That may sound to many people like a slam dunk: what else could it possibly be? There are, however, several other possible concepts. One which our committee examined quite carefully is what we called an auction-value approach. This is an essentially prospective approach that looks at estimated future flows of benefits, premiums, etc., in arriving at a figure that would be appropriate if, in fact, there was an active and objective secondary market for life insurance policies. After considerable discussion, a strong majority of the committee wound up in favor of sticking with the asset share approach. For one thing, we saw a number of practical difficulties that we thought would be associated with implementing an auction-value approach. One is that if such an approach was to be workable over a reasonably long period of time, some of the parameters (e.g., interest rates) would probably have to be set forth on a dynamic basis. This could be quite difficult from an understanding and implementation standpoint if it were to be one of the bases for minimum nonforfeiture value legislation. An associated point is that since projections or estimates of future cash flows under the policy would obviously be involved, it would seem that these projected flows would have to include nonguaranteed elements. This was something that worried us in terms of a basis for minimum nonforfeiture legislation. Finally, a hurdle that most committee members weren't able to jump successfully was that an auction-value approach has this interesting property: if you look

at Policy A and Policy B, which are totally identical except that Policy B has a higher premium, then Policy B will have a lower auction value. This is okay from a theoretical standpoint, but many of us were troubled as to what its impact would be in the real world.

Our next major conclusion was that the current Standard Nonforfeiture Law is still essentially workable as a basis for minimum nonforfeiture benefits. Our committee suggested adoption of the guaranteed maturity premium approach, and we believe this approach will do a more than adequate job of handling flexible premium contracts, especially when compared with some of the alternatives.

The primary alternative, of course, is a retrospective approach and the next point in the summary indicates that we explored such a methodology but do not endorse it. I believe that when our committee was first formed, a number of people expected that we would do a quick job by saying: 1) the present standard nonforfeiture law is fine for traditional par and other fixed premium policies, and 2) here's a proposed retrospective approach to use for minimums on nontraditional or flexible premium policies. However, we felt quite strongly that a mixed approach like this could lead to a lot of trouble because it would provide incentives for companies to play games with minimum nonforfeiture legislation. We believe that if there was a prospective approach like the current standard nonforfeiture law for minimums under one block of product designs and a retrospective approach for the others, there would have to be a pretty wide gray area in between the two blocks, where minimums would not always be the same for similar policies depending on whether they were classified as traditional or nontraditional. We felt that this would be a very undesirable situation and therefore decided to propose that the next generation of nonforfeiture legislation should be based on one underlying methodology -- either essentially prospective or retrospective -- for all types of life policies.

We also recognized what we believe to be a very serious defect of a retrospective approach. This is that such an approach can't really be workable unless the law places caps or floors on all the elements going into the calculation of minimum values. This would lead to outright rate regulation since it would place a maximum on gross premiums for a given benefit. As stated in our summary, explicit rate regulation has not hitherto been imposed on individual life insurance, and it would preclude certain policy designs that may be quite beneficial to policy owners. I would also observe that while we received input from regulators on many types of problems they have with current law, no regulators said that they believe current nonforfeiture legislation permits premiums that are too high. The marketplace is going to take care of that.

Our next conclusion was that cash surrender values, if provided, should have minimum standards linked to the fund that provides minimum paid-up insurance values -- but that minimum cash values should be allowed to be as low as 90% of such funds. Up to now, there has never been any recognition in minimum cash and nonforfeiture value legislation of the very important fact that there is a cost -- which can be significant -- associated with providing book value guarantees on cash values which will be applicable regardless of when the surrender is effected and what economic conditions are at that time. We believe our "90% proposal" is a simple, reasonable and viable way of recognizing the existence of this cost.

As an alternative, we think companies should be allowed to make what the summary calls "economic adjustments" to cash values under basic criteria which are spelled out in the report. Perhaps a more familiar term for these items is market value adjustments. We strongly believe that this approach is a good idea whose time has come and should be permitted in the next generation of nonforfeiture legislation.

Our last two conclusions are in areas where we believe there is a lot of potential trouble, a lot of worry right now, no clear solutions, and therefore plenty of problems in areas that largely can't be dealt with under nonforfeiture legislation. We do, however, feel quite strongly that these areas should be addressed, and therefore, felt it important to draw attention to them in our report.

What we're talking about is a recently developed family of nonguaranteed pricing elements. One word that has been used for some of them is persistency bonuses, although they come under a lot of names and in many different basic designs. Right now, they are subject to virtually no regulation. Some of them have every appearance of being designed to recognize past gains. In these cases, we are proposing that some of the regulatory patterns applicable to dividends ought to be applicable to these elements also, but without making the underlying policy a par policy.

Finally, just as is generally the case with dividends under a par policy, we believe that non-guaranteed elements other than dividends should be nonforfeitable once they are credited -- subject only to the same surrender charge adjustments as applicable to other guaranteed portions of the insurance fund values.

That's the sum and substance of our conclusions and recommendations. They will first be discussed in any substantive way at two meetings in early December -- of the NAIC Life and Health Actuarial Task Force and the Standing Technical Advisory Committee which is an industry advisory committee to the Life and Health Actuarial Task Force. It will be interesting to see where we go from there. We don't realistically expect the regulatory community to embrace each and every one of our proposals with open arms. I think the NAIC will form a successor committee to codify and implement these proposals as modified by regulatory and other input. Speaking for our committee, we hope that when work on the next generation of nonforfeiture legislation has been completed, it's felt that we made a significant contribution.

MR. PHILIP K. POLKINGHORN: I'd like to talk a little bit about the impact that Walt's committee report might have on nonforfeiture structures in the future, and I have a few comments about how nonforfeiture structures might evolve after that. Also, I'd like to spend some time talking about unusual sorts of products that are being offered under today's nonforfeiture laws that, to put it bluntly, stretch interpretation of existing nonforfeiture regulations. In talking about cash value structures of the future, before we can answer what they will be, we have to think about what they should be -- and that's very subjective. Walt can probably tell you that their committee had a fair bit of discussion and disagreement over the fine points. I think we also have to look at how standards are chosen. What's the practical environment that a committee like Walt's has to work under? What do the various parties involved want? What do our customers want? What do our stockholders want? And what do the regulators want? Deciding what our nonforfeiture structure should be is like putting a puzzle together where all the pieces don't necessarily fit.

We also have to look at the concept of disclosure, I think, which is very closely related to the concept of equity. Equity is very subjective and if you ask ten people to tell you what is fair and what isn't, you'll get at least six different answers! I think there are a number of people who believe that with respect to the sale of insurance, it's sufficient to have equity at the point of issue. Practically, it is very difficult to guarantee equity at each point in time throughout the life of a contract. Generally, it is held that equity has to apply across very broad classifications of policyholders.

There generally have been limited adjustments for changes in circumstances. The standard non-forfeiture law typically mandates a set of benefits that will be provided without regard to changes in circumstances. Rob Worley will talk a bit more about what his firm does to give people a different value if they have a change in circumstances. For example, the general concept in today's nonforfeiture law is that a customer should receive the present value of future benefits less the present value of adjusted premiums. Obviously, if someone has contracted cancer, after issue, the present value of future benefits is higher, and fairness would seem to dictate that they should get more upon surrendering their policy than the standard. But, in general, few adjust-ments are made after issue.

It's been held that equity should be maintained between persisting and terminating policyholders. This is in contrast to those who believe that it's sufficient to maintain equity at issue. I'm not sure how many of you read "The Standard Nonforfeiture Law: In Need of a Change?" by Mark A. Davis in the September 1990 *Product Development News*, which basically questions this long-standing premise. It suggests that in practice, businesses reward customers who have been with them the longest. The article makes an argument that perhaps we don't need equity between persisting and terminating policyholders. But, this has been a principle that's been with us for a long time, and I don't think it would be easily challenged.

In analyzing what nonforfeiture benefits are required, I think we also need to look at the concept of disclosure. In general, one might argue that insurance companies and their customers ought to be able to make whatever bargain that they want as long as both are well informed about the arrangement. And I think this is what we try to do with disclosure. If we provided customers enough information, then we could have more freedom in the types of bargains that we are able to make.

The problem is that very few regulators believe that disclosure alone really works. Our products are complicated. It's difficult to explain them in a few meaningful figures or interest-adjusted costs, and more figures are not really the answer. There has been some talk that perhaps we should disclose the nature of the values as much as the absolute value or the size of the cash values. Walt mentioned companies dealing with persistency bonuses as an obvious case where terminating policies suffer to the benefit of those who persist. And perhaps something should be disclosed about the nature of those values as opposed to how large they are. Buyers should understand that persisting policyholders benefit at the expense of those who terminate. Years ago, companies sold deferred dividend policies, which are similar to policies with persistency bonuses. Now, as it happens, people realize that under such policies they are benefiting at the expense of terminators. The question is, do all the people who are currently buying these types of policies know what they are getting? The answer is probably no.

In looking at what nonforfeiture values should be, I think we have to look at what today's real problems are. Are they that nonforfeiture values are too low? I don't think so. I would doubt that there are very many companies who have been in trouble with State Insurance Departments because they offered contracts that didn't meet the standard nonforfeiture law. I think a greater concern is unrealistic illustrations, and these have very little to do with guaranteed values. They have to do with nonguaranteed values. Probably the industry has gotten into a bit of trouble by selling cash values as opposed to protection. We've gone through a wave of activity where we've greatly emphasized the investment aspects of our products as opposed to the protection aspect. In general, consumers don't care about the cash value curve; they care about how big the cash value is relative to the premium they were charged. They also tend to care about what they get when they want to get out. They don't care about what the 20th year cash value is if they lapse in the 15th year. They all have differing risk profiles. There are probably several of them that would be willing to buy a policy that had a lower cost with a trade-off of substantial penalties for termination. They care about affordability. They want to know that they can get the coverage they want at an affordable cost, and they care about stability. By and large, people prefer level cost. I think one has only to look at the dismal success rate of adjustable rate mortgages to see that people will hang on to something where they can predict the cost.

The regulators, care about the cost to consumers as well, and I think we've seen several proposals for nonforfeiture structures that amount to rate regulation. This is because cost is important to consumers and, therefore, the regulators care about it. Probably what's more important is that customers are treated fairly. Because, if they aren't treated fairly, that's when the State Insurance Department hears about it. And finally, although not directly under the nonforfeiture law, the regulators should want to promote nonforfeiture regulations that will help companies to remain solvent, and as Walt mentioned, their committee came out with a recommendation that there be some economic adjustment reflected. There is a substantial cost associated with allowing book value withdrawals to policyholders.

But what do companies want? They want a structure where they can make reasonable profits and where they can offer products with structures that don't threaten their solvency. They also care about meeting customer wants; without the customers, there is no company. I guess one example is the market-value-adjusted products. I fail to see how some companies think they're going to be successful taking the same annuities that they sold without market-value adjustments and putting market-value adjustments on them. I think there has to be something in it for the policyholder as well, and some companies have responded with longer interest rate guarantee on market-value-adjusted products. However, other companies are offering market-value-adjusted products with a guarantee no longer than the guarantee on their book value withdrawal products. They are their own worst competition in that case.

The companies would like to have operating flexibility. It takes a long time today to get products up and ready for market. Rigid rules can limit a company's ability to experiment with different coverages, and they want a nonforfeiture law that doesn't build constraints relative to competition. We don't want something that is good for one class of policies and not another. What are some general precepts that people want for the way we operate and do business in this country as a whole? I think generally we believe that people with the capital at risk are the ones who make the pricing decisions, and that would argue strongly against any sort of rate regulation. You're free to complain as much as you want about the price of something and if you think it's too high, you look for another price. If you think that there aren't any reasonable prices out there, it's an opportunity to offer products at a lower price and clean up. The people who organized

Proposition 103 probably would be very, very offended if we were to put a cap on lawyers' incomes and roll them back to the 1980 level. Generally, we believe in a free market and a buyer-beware attitude. Our society recognizes that people will make bad bargains and we let them do that. Probably one of the reasons that we have a need for regulation in the life insurance industry is because the impact of making a bad bargain, when you're dealing with your financial security, is so severe. It's a little bit different than if you're just going out and buying a car or an appliance, and you overpay or make a bad deal, or if you join a health club and decide to move and the membership is not transferable. It's not quite as bad as if you make a poor insurance decision, and then the benefits you really need are not there.

And finally, we do believe that we need regulation in terms of protection against unfair practices. We believe that the buyer should beware, but we want to make sure that people are being honest in their dealings with each other.

I think if we look at how nonforfeiture values are developed, we can look at the report that Walt just gave and we can look at the law of physics -- a body at rest tends to stay at rest. There's not going to be a lot of change unless there are other forces that bring that about. I think that we're going to have larger changes if something happens that changes the viability of the products that we sell today, and then we'll see major changes in the standard nonforfeiture law. The standard nonforfeiture law as currently written does work very well for the types of products we're selling today. It might not work as well for the types of products that we need in the future. I think that the more rigid the nonforfeiture law is, the less quickly we'll be able to move if we are faced with a threat to our current products.

Well, looking at how nonforfeiture values are developed, we can look at the questions Walt's committee asked themselves. They had to deal with some very practical results. They had to take their recommendations and sell them to a very broad public that I just mentioned. The regulators had to think that it is at least somewhat reasonable. The industry which this regulation is going to affect had to feel that it's reasonable. So, looking at whether or not the values will continue to be mandated and coming up with a conclusion of yes, is probably very reasonable. It's very difficult to envision taking a report to the NAIC Actuarial Task Force and saying, "We've decided that these really don't have to be mandated any more." It probably would have been a lot of work for nothing.

The group came to the conclusion that they should be based upon the asset share. I think that this is a logical conclusion and it's one that's acceptable given the different areas that they looked at; however, when it comes into practice, the nonforfeiture law doesn't recognize differences in asset share between different products. It's an attempt to make up one set of factors that works for everybody. It works for a good segment of the mainstream products, but it doesn't recognize premium level because that's too close to rate regulation. One thing that probably would be good is if there was a way to recognize that lower premium products should have lower paid-up values. I think Walt mentioned that looking at the auction value and the fact that policies with higher premiums had lower values caused some concern.

Retrospective methods were considered but not developed further, and they made the point that the regulation of nonguaranteed elements may be necessary at least to the extent that dividends are regulated.

What would I personally like to see in future nonforfeiture structures? I'd like to see that both companies and customers have more flexibility in the types of contracts that they can enter into. If both parties knowingly want to enter into an arrangement, who are we or who are the regulators to say that they shouldn't be able to do so? We're protecting people against doing something that they might well want to do. I think that if companies had more flexibility, the market would quickly tell us what sort of products were good ideas and what sort were bad. I think that probably given what today's real problem is, and I don't think that it's that nonforfeiture values are too low, we need something that provides more protection against unfair practices. The problems really arise when people don't know what it is that they've bought. In short, I think we need fewer bright line tests. I think that bright line tests really don't protect customers. Saying that this is the minimum nonforfeiture value for this benefit is not very effective in providing protection to customers and doesn't address some of the real problems that are out there today. I think that a better policy would be to regulate market conduct. This is very difficult and it's probably the reason why more of it hasn't been done. You have to point a finger at somebody and

say, I think what you're doing is unfair. Whereas, with a nonforfeiture law, you can point and say, you either meet or don't meet this law, and try to find fairness with the bright line test.

What sort of things are companies doing today? Some companies are going for products that technically wouldn't be permitted under today's nonforfeiture law. But, through one hoop or another, they're managing to sell zero cash value look-alike policies. These are policies that, on a current basis, offer a level premium for the whole of life, but no cash withdrawal benefits. Such a policy really isn't permitted under the standard nonforfeiture law. However, the standard nonforfeiture law has as one of its deficiencies that it deals primarily with guaranteed benefits and not current benefits. In today's insurance environment, and with the volatile economic times that we're facing, very few people make decisions based upon the guarantees, partly because the disparity between guaranteed values and current values is so great.

Using policyholder persistency bonuses, people are changing the slope of the cash value curves. Again, this is possible because by and large, the smoothness test is applied to guaranteed values and not to current values.

Market value adjustments have not been used much in life insurance, but in annuities, many companies are experimenting with them. Companies are developing group products that are really sold on a pseudoindividual basis to get around some of the restrictions in the nonforfeiture law.

In Texas, they have a regulation that permits the sale of life insurance policies with no nonforfeiture values. The design is very restrictive. They can be level premium policies only. Participating versions are accepted, but no adjustable premium versions are accepted. The State of Texas is currently working on valuation and disclosure rules that have to be put in place before these policies can be approved.

What sort of things might we see if we had a more flexible nonforfeiture law? I think we could see policies with indifferent values; the company is indifferent as to whether or not the policyholder surrenders. Reduced paid-up values would be calculated such that the company doesn't care if they're surrendered or not. This chart may be familiar to some of you who read the article by Mark Davis that I mentioned earlier. He was talking about the types of products offered in the U.K. versus the types offered in the U.S. He contrasted the financial returns to the company and the cash value returns to the policyholder for a typical front-end load universal life (UL) policy in the U.S., a back-end load universal life policy in the U.S., and the U.K.-style policy. In the U.K., all the premium is taken as loading until the company recovers its costs and a small profit, and thereafter, the mortality and interest elements are substantially on a break-even basis.

Mark gave me permission to use this chart (Table 1) and I added a column because he solved for equivalent profit margins for all the products and compared the financial returns to the company and the cash values. He saw that longer term, the policyholders got better cash values with the U.K.-style policy. I had him add a last column that calls for the same internal rate of return. I think that this structure would not be permitted in the U.S., but it seems only fair to pass on the cost of acquisition to all those who incur them on their behalf and to pass them on as quickly as possible. That's what this sort of structure does.

Well to close, I'd like to end with my assertion that today's standard nonforfeiture law really provides little comfort to regulators. The reason is that the regulation of guaranteed values is somewhat ineffective. Uncertainty about the future makes regulation of future values difficult and we may never find a bright line test that works. I think that regulating market conduct would be much more effective, however, I recognize that regulating market conduct would also be a lot more work.

MR. JOHN E. MCKAY: My topic is nonforfeiture practices in the Canadian marketplace which, as you may know, are in considerable contrast with those in the U.S.

I'll start with a brief overview of the regulatory environment in Canada. The key point is that there is a complete lack of nonforfeiture law in Canada. From a jurisdictional perspective, we enjoy a much simpler life as well. The solvency of federally incorporated life companies is the primary responsibility of the federal government. It also takes an interest in issues of policyholder equity. The provincial governments are responsible for the licensing of agents and

TABLE 1

U.S. STYLE UNIVERSAL LIFE PRODUCTS

	Front End	Back End	UK Style 1	UK Style 2
Profit Margin	9%	9%	9%	.75%
IRR	18%	16%	94%	18%
Breakeven Year	13	13	2	2
Cash Values				
Year 10	$7,997	$8,731	$6,808	$8,109
Year 20	22,880	23,238	24,696	28,150
Year 30	47,343	47,006	65,515	75,367
Year 40	99,592	98,480	171,915	197,136

Source: Excerpted with permission from "The Standard Nonforfeiture Law: In Need of a Change?", Mark A. Davis, *Product Development News*, September 1989

companies, and for the regulation of insurance contracts. They have the authority to require the filing of policy contracts, but historically have not exercised this right. As a result, we have no policy filing requirements. Thus, with a new product or cash value structure, we just price it, get the back office ready, and go to market. This freedom has given rise to a wide variety of product and nonforfeiture approaches over the years.

I would like to look back and give you a quick summary of what has happened in the Canadian market with respect to products and nonforfeiture values over the last 20 years. In the 1970s, the traditional permanent products in Canada were very similar to those in the U.S. Cash value patterns would have been similar to those in the U.S. with the possible exception that early values may have been lower in Canada in order to more closely match acquisition costs.

Commencing in 1974, companies started to introduce "new money adjustable" policies. You would refer to these as indeterminate premium policies. These policies normally involved a recalculation of all policy values, including basic coverage or premiums, every five years. With products where the basic coverage might be adjusted downward, the policyholder normally had a nonevidence right to pay an increased premium to maintain the coverage at its original level. Given the absence of filing requirements and regulation, many different recalculation approaches developed.

Generally, all policy values were forecast for the upcoming quinquennial period. In some products, these forecasts were guaranteed, while for others, the company retained the right to incorporate into the next set of forecast values the impact of differences between assumed and actual experience during the previous period. Some products placed no constraints on the company's ability to determine the recalculation assumptions. Other products guaranteed that the recalculation mortality and expense assumptions would be the same as those used at issue. Some products stated that the recalculation interest rate would be the same as that being used in new issues at that time, while others linked it to an outside interest index. Most adjustable products contained some level of basic guarantees with respect to cash and reduced paid-up values. As well, where coverage was adjustable, there was a minimum guaranteed coverage level and where premiums were adjustable, a maximum premium level was guaranteed.

In the mid-1970s, single-premium adjustable insurance products were introduced. They created considerable controversy because of their potential use as replacement vehicles. Later in the 1970s, as interest rates in Canada started to rise, market value adjustment (MVA) clauses found their way into deferred annuity contracts, and subsequently, into adjustable products. Many approaches to the MVA clause were developed. The most common involved discounting the investment account maturity value from the maturity date to the calculation point. The interest rate used in discounting would normally equal the then current interest rate of the same term as the investment account being discounted, increased by perhaps as much as 1%.

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An interesting extension of the MVA clause found its way into the policy loan provisions of a few single-premium, adjustable insurance products in 1980-81. This was designed to protect the insurer against the disintermediation risk presented by policy loans on single premium products. Some of these single premium policies were leveraged from issue using policy loans. In this case, the policy loan rate would normally be fixed for the same five-year term as other policy values and would equal the premium calculation interest rate plus a spread. This approach resulted in the insurer facing a prepayment risk, if the policyholder repaid the loan prior to the next adjustment date and interest rates had dropped. The loan provisions of a few products provided the insurer with a remedy, in the form of a prepayment penalty, if this occurred. This exotic approach to policy loans was short-lived when in late 1981, single-premium insurance became subject to accrual taxation on the inside interest buildup.

As the 1970s came to a close, there were factors at play which created pressure for further change in approaches to nonforfeiture values. Interest rates rose sharply and then dropped suddenly in the early 1980s. In some segments of the market, there was a bias against or perhaps a mistrust of cash value life insurance. Distribution costs were higher in Canada than in the U.S. High acquisition costs coupled with poor persistency rates on in-force business had many companies worried. New products and lower premium rates per $1,000 had created a situation where replacement of older, in-force policies could easily be justified, or at a minimum, rationalized. Given the speed with which new products were hitting the street, there was fear that any sale could be a replacement target in a couple of years.

Reserve standards changed in 1978 with the introduction of the valuation actuary concept. Previously, the valuation interest and mortality assumptions had been set by the federal government and lapse or surrender rates did not enter into the reserve calculation. After 1978, the reserve assumptions were to be set by the valuation actuary who could also take lapses and surrenders into consideration. The ability to factor lapses into reserve calculations turned out to be a key to some later developments with respect to nonforfeiture approaches.

During the late 1970s, a lot of companies entered the brokerage market with many of them in essence competing on going-in cost. The combination of the above factors and increasing price competition in the brokerage market lead to the introduction in 1980 of "no cash value" products. Many of these products were adjustable in nature while a smaller number were fully guaranteed. The primary attraction of these products was low price in relation to products already in the market, since many of them were developed near the peak of the interest rate cycle. At the market level, there was a mistaken assumption that the price attractiveness was due to the removal of cash values, when in fact for most products this was not the case. Most of these "no cash value" products would have offered reduced paid-up insurance as a nonforfeiture option. By today's standards, these products would not have been considered "lapse subsidized."

UL policies were introduced in Canada in the very early 1980s. Initially, the products were front-end loaded. In order to produce better illustrations, a move to back-end loaded products eventually began. As in the U.S., we have now evolved to the stage of illustration wars where the best projection all too often wins -- even when its wisdom should be questioned. With respect to cash values, most UL policies will contain an MVA clause where the underlying investment model is based on anything other than short term rates. Inclusion of such a clause in a UL product has, at most, a marginal negative impact on marketability.

The 1982-84 time frame saw the development of another new approach to product design and nonforfeiture values in Canada. A number of factors contributed to this. Interest rates had fallen sharply from their earlier elevated levels. The adjustable products, which a few years earlier had looked very glamorous, were then on the wane as the pricing for new issues increased. In addition, there was increasing concern at both the company and agent level about the negative adjustments which would likely occur at the first adjustment point on policies sold in 1980-81. As a result, interest guarantees again became fashionable as a means of limiting the negative impact of interest rate changes on policies. All the while, the importance of price competitiveness in getting market share for many companies had not diminished. The response to these conflicting factors by a number of companies was the development of a new product which became known as term 100.

Term 100 policies in the Canadian marketplace will generally have the following characteristics:

1. Very low or perhaps nonexistent nonforfeiture values, either for the life of the policy or for many years.
2. All policy values will be fully guaranteed for the life of the policy.
3. The pricing will be lapse subsidized, i.e., the pricing will use the values anticipated to be forfeited by those who lapse to reduce the initial price of the product for everyone.

There is a range of practices with respect to nonforfeiture options. Some products have no nonforfeiture values whatsoever and endow at age 100. Others have cash and/or reduced paid-up values commencing at the 20th policy anniversary. To protect the policyholder against an inadvertent lapse, some products offer an extended grace period of 90-180 days. Some products even offer a one-time cash value or reduced paid-up value, say at age 65. The policyholder will have a period of time surrounding the option point during which to take the nonforfeiture value; if not taken during this period, no subsequent nonforfeiture values are available.

Premium rate levels on term 100 products are quite low in relation to other permanent products, including UL. For example, the premium per $1,000 for a male, 40-year-old nonsmoker will be in the $3.50-4.50 range. These products are also sold on a joint and last survivor basis. For a male and female, both age 50 and nonsmokers, the premium per $1,000 will be in the $4-5 range. The market attraction of these policies is the extremely competitive pricing and the fact that the interest rate risk has been removed for the policyholder.

There are a number of important pricing and design considerations in developing a term 100 product. The long-term interest rate is obviously a key assumption. It plays as important a role in determining the premium level as do the assumed lapse rates -- which are also key. The higher the assumed lapse rates are, the lower the premium rates will be. It is essential to consider the markets in which the product will be sold. I have seen a number of market applications for term 100 where there are likely to be almost no lapses. Insurer income tax considerations must also be contemplated. For example, two years ago, an investment income tax on the inside interest buildup was introduced. This tax is to be collected at the company level. Because all details of the tax were not finalized until long after its effective date, companies in general were slow to reprice their products, including term 100, to reflect the impact of the tax. It eventually became clear that the tax would unintentionally have a heavy impact on term 100 policies. Unfortunately, companies have no ability to pass on the cost of this tax to term 100 policies sold after the effective date of the tax but before taking any corrective pricing action. Given the fully guaranteed nature of the pricing of these products, the handling of the mortality assumption, in light of the danger posed by AIDS, is much more difficult and important than with other permanent products.

Let's now look at industry and market acceptance of term 100 products in Canada. Initially, at the industry level, there was considerable divided opinion about these products. Those opposed expressed fears of inadequate reserve levels and the potential impact on company solvency, of likely consumer complaints down the line as policyholders surrender their policies without value, and of the possibility that term 100 policies might ultimately precipitate the development of nonforfeiture laws in Canada. Those in favor argued that the product offered the consumer the choice of permanent protection at a low and guaranteed price. Today, a large number of companies offer a term 100 product of one form or another. As always, at the market level, there is considerable support for lower prices, and hence, for term 100. In many cases, the client's other advisors, whether they be accountants or lawyers, are often attracted to term 100 over other permanent insurance alternatives. For them, the easiest and seemingly safest recommendation with respect to insurance is the cheapest one.

The term 100 concept has recently been extended to UL policies in Canada by a couple of companies. They have effectively imbedded a term 100 with a UL policy. The UL policy operates in the conventional fashion other than the cost of insurance (COI) rates are based upon issue age and not attained age. It remains to be seen whether this product form will gain much market acceptance.

The regulatory environment enjoyed in Canada, and in particular, the lack of nonforfeiture regulation, have spawned much product innovation over the last 15 years. In the short run, this has provided real benefits to the public, particularly in the form of competitive pricing. There

are some future concerns, however. One is the handling of the losses that may emerge if lapse subsidized policies do not experience sufficient lapses or if for some other reason the products are not profitable. How well will such blocks of business be serviced by companies? Does a company have a sufficient financial motivation to properly service a mature block of this business? Many years down the road, will the policyholder remember that there are no values in his policy, or that they are not available for another five years, even though he wants out then? This potential problem for the policyholder may be overcome if a secondary market for term 100 policies were to develop. This is a possibility, but it could lead to potential solvency issues for some issuing companies.

I would hope that the freedom we as an industry enjoy and how we handle it never leads to the establishment of nonforfeiture laws in Canada. In my opinion, that would be a step backward.

MR. ROB T. WORLEY, JR.: My background is as a life insurance agent. I've been in the life, health and disability insurance business for close to 14 years. I'm an independent agent rather than a career agent and I sell for a number of companies. Recently, along with my father, I formed the first company of its type in the nation. This company, Living Benefits, Inc., purchases life insurance policies from people who are terminally ill. I imagine many of you have heard of us. For those who haven't, I'm going to give you a brief overview of our company, what we do, and our opinion as to the future of cash value structures.

Two years ago, I had been to see some clients in the southern part of the state, and on the four-hour drive home was listening to a nationally syndicated talk show on the car radio. A young man called in with a problem and the host offered to see what he could do to help. The young man was 36 years old, had never been married, had no children, and his parents were dead. He had a $100,000 life insurance policy that he had bought four years earlier from a friend just getting started in the insurance business. He had just been told by his doctors that he had six months to live. Since he had some things that he wanted to do and places he wanted to see before he died, he called the insurance company and offered to make a deal with them on the policy. He offered to give them back the policy for $50,000 and then pointed out that this would save the company $50,000 in the next six months. The company apologized, but said that this type of arrangement was not possible. The young man then called the largest bank in the city where he lived and made them the same offer. Because speculation in human life is a violation of federal banking law, the bank was unable to accept the young man's offer. The young man asked the radio host what he could do. Unfortunately, the host didn't have any answers.

Over the next few days, I called several of the companies that I routinely write business with and asked if they ever received calls such as the one outlined above. Each company told me that they probably averaged four calls per week. That sounded like a lot to me and I felt that there should be a way to help these people. After discussing it with my father, we hired a prominent law firm in Albuquerque to determine two things: 1) Could a company be set up to make loans based on a large percentage of the face amount of a policy? Or, if not, 2) Would it be possible to form a company to purchase the policies for a percentage of the face amount? After a year-and-a-half of extensive research, we were advised that a company to purchase policies from terminally ill persons could be formed.

Living Benefits, Inc. bought its first policy in April of this year. Since that time, we have purchased approximately 30, with an average face amount of over $100,000. We purchase the policies for between 55-80% of the face amount, and we deal in all 50 states. We receive calls constantly. On the average, 90% of our business comprises AIDS patients, with the remaining 10% being persons with cancer. Basically, due to medical expenses, these people have become financially destitute. Primarily, the money received from Living Benefits is used to pay the rent or mortgage, secure transportation to and from medical facilities, and to insure continued medical care and prescriptions. We can say today that we know of three homes that were in foreclosure which we ultimately saved. Our clients are not out walking on the beach in Tahiti. They tell us the most heartbreaking stories and it gives us a wonderful feeling to be in a position to be able to help.

A large percentage of terminally ill people lapse their life insurance policies. An insurance premium becomes an extra expense that just can't be paid. We have talked with three different financial planning firms in New York who limit their practice solely to the terminally ill. These planners tell us that by the time someone seeks their services, between 60-70% will have lapsed

their policies. It seems like a crime that you pay the premiums on your policy for a number of years and when it appears you need it the most, you have to let it lapse because you can't afford it anymore.

We have created quite a stir in the insurance industry to say the least. Our whole premise is that a change in circumstances dictates a change in the cash value or market value of the life insurance contract. Insurance companies have not responded to that until now, with the advent of the Accelerated Benefits Rider. Obviously, the life insurance policy, in its own unique way, has a potential tremendous future benefit. Once a person's life expectancy changes, you can discount the future value and come up with a market value at any given point in time.

How does this affect the actuary? I don't know how to answer that question. I'm obviously not an actuary. I'm a marketing person. You are the ones who do the magic that create the products I sell. I have a very limited understanding of exactly how you do that, so I am dealing more from a marketing standpoint, rather than from an actuarial point of view. Ultimately, as I see the life insurance contract, there need to be adjustments in cash value based upon changes in a person's mortality. I think it is going to take a lot of time and effort to find a solution. As I mentioned before, Accelerated Benefits Riders are the beginning of the answer. Until last week, there were only 40 companies, to my knowledge, that had offered this new rider. Basically, to a given maximum, these riders allow you to borrow up to 25% of the death benefit if you become terminally ill. I've seen this maximum be as low as $10,000 and as high as $250,000. However, these companies all have a limited set of acceptable terminal illnesses that would allow a policyholder to obtain the loan. It is interesting to note that AIDS is never listed as an acceptable illness. Just last week, the 41st company made this type of benefit available to its policyholders, although as a policy provision rather than a rider, and accepting a maximum life expectancy of two years. This company accepts all terminal illnesses and makes 25% of the death benefit available. I think this is a step in the right direction. However, in addition to changes in the maximums, I would like to see the percentages higher. Eventually, I would also like to see all contracts issued with this benefit as a policy provision rather than a rider (which is an added cost to the insured).

Cash value is normally based on expected premium inflow from the insured and expected benefits paid to claimants; but anything that affects the timing of expected cash flows under an insurance contract affects its market value. Obviously, a change in life expectancy is probably the major thing that can affect the market value. We are focusing on the market values strictly. If a person is terminally ill and needs money, he can surrender his policy to the insurance company or borrow against it. Interestingly enough, of all the contracts we have purchased, the one with the largest cash value had $4,000 available. We paid that gentleman $72,056 for his contract. I am sure the insurance company involved would have been more than happy to give the insured $4,000 and be "off" of the death benefit liability.

Are there some moral issues in what we are doing? Yes, I'd be the first to admit that. It is interesting that one of the first things we were accused of by the insurance industry is not having an insurable interest in the life of the insured. We are considered a third party and as such, do not have an insurable interest in the insured. However, whether by case law or by statute, in all 50 states in the country, transfers to a third party with no insurable interest are perfectly legal and valid. Being a marketing person for insurance companies, it seems ironic that they would be spending thousands and thousands of dollars in their marketing departments trying to convince life insurance agents and brokers to sell insurance to "third parties" who have no insurable interest in the proposed insured. The catch word for this type of insurance is "charitable giving" of life insurance. A great sum of money will be spent putting together sales programs that encourage agents to sell an insured's favorite charity a policy on his life. The charity does not have an interest in his continued life -- they benefit upon his death. We view our risk as being that of the question of the accuracy of the doctors in predicting life expectancy rather than how long any individual actually lives.

MR. MILLER: We've been talking about the statutory and regulatory environment of life insurance companies in the U.S. and Canada. And it has been generally concluded that the insurance statutes and regulations in the U.S. probably don't apply to the operations of companies like yours, Rob. If that's true, under what regulatory provision are you operating?

MR. WORLEY: We are regulated by New Mexico's Department of Insurance. Previously, there was no provision for regulation of this industry. We got a bill passed through the legislature in January of this past year creating a special section of the insurance code allowing regulation of us by New Mexico's Department of Insurance.

MR. MILLER: What impact does that have on the level of your rates or the size of the offers that you make for these policies?

MR. WORLEY: We are not regulated in the amount that we offer for a particular contract. Basically, our offer is based primarily on four factors. They are: the face amount of the policy, the current prime interest rate, the premiums that are payable upon the policy because we become owner, beneficiary, and premium payer on the contract for as long the person lives, and the administrative charges; it costs us approximately $1,500 per policy to obtain the medical records and to have our physicians review the medical records.

Also, we only purchase approximately 50% of the policies that apply, so we have to recoup administrative charges for the 50% not purchased. We also have charges like rent, phones, and federal express mail. We don't, however, take any money out in the form of salaries for those of us that are working there. I have income from my insurance agency, and my father who is also involved in this company has income from elsewhere. At this point, we are just trying to make this an on-going company and we admit to each one of our potential clients that we are perhaps paying 5-6% less than we actually should. We think our numbers are accurate within that kind of range. We may be paying 5-6% too little or 5-6% too much, because the sort of data base that we need for the accuracy of the doctors in predicting life expectancy doesn't exist. We, therefore, have to build our own data base, and obviously, as more experience is accumulated, we will be able to fine-tune the amounts we are paying.

MR. JAMES M. SCHOEN: What are the tax considerations both to the policyholder and to you upon payment of the early death benefit?

MR. WORLEY: Currently, it's a taxable event for the individual concerned when we purchase policies. I understand that there is going to be a bill introduced into Congress to change that law sometime in the next session. As far as the tax impact to us, we have to capitalize the expenses on the policies that we purchase and can expense off the cost on the policies that we do not purchase. We are taxed basically on the difference between what we receive in the way of policy proceeds and what we pay for the policy plus expenses.

MR. STEVE M. LARGENT: I have a question for Phil Polkinghorn on the bonus interest provisions. Do you know what impact these provisions have on early cash values and on Section 67702 requirements?

MR. POLKINGHORN: Are you referring to bonus interest on Universal Life plans for example?

MR. LARGENT: Yes, the ones which provide a retrospective increase to the crediting rate after a policy stays in-force for 10 or 15 years.

MR. POLKINGHORN: Those obviously have some impact on early cash values. These same contracts could be offered without the bonus and with higher early duration cash values.

As to the state approval process, there are probably four or five states who react unfavorably to these types of bonuses on various grounds; there is not uniform reaction from these states, however. There are probably other states who don't particularly care for them but realize that most of these are nonguaranteed. If they are guaranteed, then the nonforfeiture law currently has a smoothness requirement that many of these contracts would fail. I should point out that there are some persistency bonus contracts that would pass the smoothness test. With the exception of perhaps three or four states, most states for some reason or another have not been requiring Universal Life contracts to demonstrate that they pass the smoothness test, so probably you can get fairly wide approval of these. For some products, the bonus is invisible in filing materials and, therefore, some may have been approved without the knowledge of states who would otherwise object.

PANEL DISCUSSION

MR. LARGENT: Would you have to consider the extra interest in your next Section 7702 premium test?

MR. POLKINGHORN: I think that you do if it's a guaranteed benefit. If it's a nonguaranteed benefit, then I think you can ignore it.

MR. OWEN A. REED: No matter what you do about guaranteed cash values, there is a cost to them in terms of company profitability. I come from a multinational company which operates in Britain, Canada, and the U.S., and it's interesting to see where the cost hits you in each of these countries. In Britain, the traditional products have heavy equity backings, and yet some of the most competitive companies there provide guaranteed cash values, even though they are not required. The only way a company can operate properly in that environment, when you've got something like 90% equity backing, is to have a large surplus, and some of those companies have surplus up around 40% of liabilities on a market value basis.

John McKay referred to the lapse-supported products in Canada. What happened shortly after those products hit the market was that the regulatory authorities became concerned about the reserving end of the business. They did their sensitivity testing and they found that just by changing a few of the assumptions, they can change the reserve drastically. Very shortly, there were stringent reserving requirements locked in and for term-to-100, for example, the initial reserve is typically 3-5 times the premium.

One of the worst situations I think is in the U.S. where you seem to have these high early cash surrender values. When lapse rates are way up, we seem to be shooting ourselves in the foot. We all agree that we are not covering our expenses in those situations. You can gather from my remarks that I would have been much happier if Walt's report had gone forward recommending no guaranteed cash values, but I guess as a second best, paid-up values as a requirement isn't all that bad.

MR. MATEJA: I want to interject one of my own comments. I winced a little when John McKay described the term-to-100 policy. I am valuation actuary for the Aetna, and I would be concerned about the need for additional lapses in order to make this policy self-sufficient. I'm not sure what the Chairman would think about something like that, but he has made it clear to me that the reserves should be sufficient. At some point, I suspect that the marketing people and the valuation actuary would have some interesting discussions.

MR. ALAN MARK EMMER: It seems that companies have become very comfortable with cash values as a marketing feature, for example, in retirement funding and deferred compensation. My question is, what is your recommendation on last-to-die policies? Do you recommend the one-status or three-status approach to cash values of these policies?

MR. MILLER: As to the absence of cash values possibly leading to lost market opportunities in areas where cash value features of life insurance policies have been beneficial from a marketing standpoint, I would just like to reemphasize that our committee was dealing with minimum standards for cash and nonforfeiture values. I don't think any minimum nonforfeiture legislation would preclude a company from providing amounts greater than minimum.

As far as the survivorship question is concerned, I am not a technical expert in this area, but my general attitude would be that I don't think it should be an aim of minimum nonforfeiture legislation to, in effect, legislate for or against specific policy designs. So, I would hope that we would not end with legislation or any regulation that precludes one of these two major products. Companies should have their choice.

MR. POLKINGHORN: About a year ago, I attended a Society meeting in Canada where a Canadian actuary compared term-to-100 products to a similar product that had paid-up values. The paid-up values were termed "indifference values," where the company was unconcerned as to whether or not the policyholder lapsed or kept his policy. The premium differential seemed relatively small between those two products. Has there been more development in Canada of products of this type?

MR. MCKAY: I am unaware of any significant developments in the marketplace of that type. Going back to even 1980, I have been involved in the development of products which have no cash

values but had paid-up values. The paid-up values were defined in terms of indifference values, because the objective of the exercise was to make the company indifferent from a profitability perspective as to when the policyholder lapsed. But there is a strong attraction in Canada right now in certain market segments for term-to-100. To take away the cash values and offer only reduced paid-up (RPU), you would meet market resistance unless you can give a substantial improvement in price or offer a very attractive RPU. I don't think that form would really gain much market share unless you can substantially improve price.

MR. MILLER: On the general subject of term-to-100 type policies, I was interested in Owen Reed's comment that the standards that have been set forth for valuation of these policies in Canada frequently provide for initial reserves that are several times the premium. In Texas, there is an actuarial advisory committee that has been set up by the Insurance Department which is going to make a recommendation as to what a proper valuation basis for these policies should be. The advisory committee has, to put it mildly, not been unanimous in its proceedings. The way it looks right now, they are going to recommend a valuation basis that involves standards pretty much according to what is mandated in Canada, which allows an interest rate higher than a normal valuation interest rate and a lower mortality than that used for the regular reserve basis. The lower mortality basis is important for the purpose of testing whether a deficiency reserve is necessary. It is my impression, and I know some may disagree with what I'm about to say, that the only real justification that has been offered for this special mortality basis is that without it, the deficiency reserve requirements would be so extreme the companies couldn't price the policies so they can sell it.

MR. POLKINGHORN: I feel compelled to comment since I'm on that actuarial advisory committee. We haven't issued a report yet, but we are meeting again in November 1989 to finalize the recommendations. The lapse rates in the valuation standard are lower than the lapse rates in the Valuation Technique Paper #1 in Canada. We have been a bit more conservative on lapse rates than the Canadian Institute.