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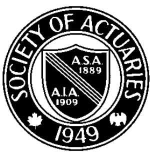
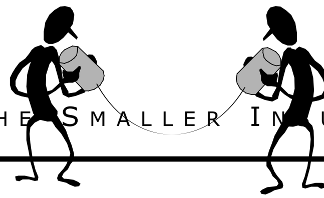


small talk

NEWSLETTER OF THE SMALLER INSURANCE COMPANY SECTION



ISSUE 16 DECEMBER 2000

History of the small Policies

by Julie A. Hunsinger

The October 1875 issue of the Insurance Times, a month before the American Prudential opened, contains a quote that is still relevant today:

> *Who needs life insurance most? The poor or the rich? The families who are entirely dependent on the daily or weekly earnings of their head, or those who have other sources of maintenance?...The complaint is general, however, that life insurance fails to reach those who most need it, and upon whom it is calculated to confer the greatest benefit.*

This quote, written before the advent of the small policy in the United States, explains why insurance is now offered in smaller units: to provide it for *those who most need it*.

The current NAIC investigation into small policies is an investigation into fair policyholder treatment of small face value life insurance. To fully understand this type of insurance, we must understand its history.

From the ancient Mediterranean world up to 16th century England, individual underwriters issued life insurance to merchants and travelers who were generally wealthy. The insured would pay a single premium in exchange for coverage for a limited period of time, such as during a long voyage or pilgrimage. Without mortality tables, early insurance was basically a wager on whether someone would survive the coverage period, and premiums were set arbitrarily. The first life insurance companies were formed in the mid-1700s and sold life insurance policies to the public, but widely available life insurance for working class people did not arise in England

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Small Talk from the High Chair

by Edward J. Slaby

As I begin my term of service as the Chair of the Smaller Insurance Company Section, it is my duty to give the members of the Section my observations on what direction we should be heading.

I have been a smaller company actuary for over 20 years, so I think I have a lot of the same viewpoints and reflexes that are found in the membership of this Section.

My initial involvement with the Section Council was not very promising; several years ago I ran for a seat on the Section Council and was unsuccessful. Then two years ago I had a chance conversation with Chris Desrochers, then Section chair, who reminded me that all actuaries should be involved with their profession. I risked my pride and ran

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History of the small Policies

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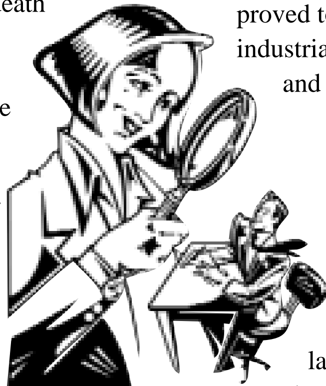
until the 1830s, or in the United States until the 1870s.

Before insurance companies were formed to serve the less affluent, many Friendly Societies were formed in England and the United States in the 1830s and 1840s to provide benefits for the working class. When death or debilitation befell a member of the group, a sum was collected from the other members in the mutual benefit method. For instance, in a group of 500, $0.10 would be required from each member to cover the $50 benefit promised by the society, with administrative fees taken from the benefit. The administrators of these insurance systems were working men with little mathematical or statistical expertise and thus were not able to foresee the problems that would plague their organizations. By 1850, it was estimated that over three million American and English working men belonged to the various friendly societies.



The insolvency of so many friendly societies soured public opinion on life insurance. In 1853, the *New York Times* denounced all life insurance, saying, “He who insures his life…must be a victim of his own folly or others’ knavery.”

In that same year, A. B. Johnson, a Baltimore banker and economic writer, echoed a popular myth when he suggested that widely available small policies in Britain had caused mothers to murder their children to collect the death benefits. However, he could never cite a single instance of infanticide.

Gradually, blind mistrust of insurance turned into debate over how lower income working people should protect against unforeseen contingencies. Most insurance experts ruled out ordinary life by the late 1860s, when some ordinary life companies tried to market small policies to the working class. These early ventures failed because no adequate system of collection was in place, and they did not provide coverage in small enough units for lower-income people.

The push for insurance for the masses was fueled by three events. The first occurred April 24, 1871, when Henry Harben read a paper before the Institute of Actuaries of England about the history of the *British Prudential*. The paper proved to the British insurers that industrial insurance did, in fact, work, and it attracted the American insurers’ attention to industrial policies. The second event was increasing public dissatisfaction with the failing friendly societies, a dissatisfaction augmented by an influx of English emigrants lauding the industrial policies of the British Prudential. The third event was the high mortality rate brought on by unsanitary conditions and malnutrition in the industrial cities. The working class demanded insurance to protect against sudden loss, and the city governments demanded mass insurance to alleviate the costs of paupers’ burials.

With increased public support, arguments for mass insurance grew stronger. In October 1874, the editor of the *Insurance Times* wrote about “the duty of supplying the need of life insurance to the industrial masses.” Earlier that same year, insurance commissioner Julius Clark delivered a report to the Massachusetts Legislature strongly in favor of implementing an industrial insurance system similar to that of the British Prudential. His report marked the end of a lopsided debate over whether life insurance for the poor would lead to infanticide and catastrophic financial ruin. Industrial insurance’s reputation had emerged unharmed, and the public clamored for affordable life insurance.

Around this time, John Dryden came to Newark, NJ to found the first industrial insurance company. He had consulted with insurance experts, assembled a board consisting of the most respected businessmen in Newark, and founded the Prudential Friendly Society (later the Prudential Insurance Company of America) in 1875. It was a friendly society in name only, for its business practices resembled those of the British Prudential.

The Prudential Friendly Society issued its first policy on November 10, 1875, and had 4,816 policies in force at the end of 1876. The Prudential grew to show success, with 43,715 policies in force in 1879 when the John Hancock Mutual Life Insurance Company and the Metropolitan Life Insurance Company of New York began their industrial policy branches. All three expanded phenomenally. In 1891, the “Big Three” as they were called, held 95% of all industrial policies in force. By 1900, Met Life had 4,855,756 policies in force, Prudential had 3,406,189 policies, and John Hancock had 1,069,197 policies.

The volume of industrial insurance business continued to increase until the mid-1950s, when the distinction between industrial insurance and ordinary life blurred. Ordinary life policies began to be issued widely on a monthly payment plan with smaller premiums on the home collection system, which became monthly debit ordinary (MDO). With higher wages than in the 19th century, the American worker could now afford to pay monthly premiums, and because the average wages increased steadily over the years, Americans could afford the larger policies they wanted and usually found them in the ordinary life market.

Recognizing this trend towards larger ordinary life policies, Met Life, John Hancock, and Prudential stopped writing new industrial policies altogether in the late 1960s. In 1973, Met Life went one step further and began to phase out its entire debit system. This resulted in ceasing to appoint new collection agents and discontinuing all its debit products.

Since then, industrial insurance accounts for very little of the new life insurance sold or in force. In 1985, it was 0.5% of all legal reserve life insurance in force, compared to 4.4% in 1965. But

The Status of Proposed Revisions to the AOMR

by James R. Thompson

When an actuary renders an opinion on the reserves of an annual statement, sometimes he also develops an actuarial memorandum describing an asset adequacy analysis. This is governed by the AOMR (Actuarial Opinion and Memorandum Regulation). Based on the company size in net admitted assets and on various ratios (annuity reserves to net admitted assets, capital and surplus to the sum of cash and invested assets and non-investment grade bonds to capital and surplus), smaller companies many have to perform this analysis and develop a memorandum.

The current AOMR requires annual analysis for companies over $500 million in assets and triennial analysis for companies over $100 million in size. Others can be completely exempt by staying within the ratios.

History of concerns

OVER THE YEARS, REGULATORS have been concerned with innovative products and newer asset types. Some companies could be participating in risky behavior and not have any analysis. The current regulation has specific rules for exemption and only addresses the amount of annuities — not UL or other products like equity-indexed life. From time to time, efforts have been made to refine this.

This year I witnessed the development of a new proposal which might succeed. At the March meeting of the Life and Health Actuarial Task Force (LHATF) and also at the meeting of the National Association of Insurance Commissioners (NAIC), the regulators all agreed they wanted to get rid of the smaller company exemptions and the mandatory seven interest scenarios for the cash flow testing but also rely more on professional judgment.

At the September (third quarter) meeting, they put an official proposal on the table for exposure. This proposal could work its way up the ladder for adoption by the LHATF, then the Life Committee of the NAIC, and finally the NAIC by March or June 2001.

This is a significant proposal. The regulators think it has been exposed enough, but I believe many smaller companies have not discussed this because of the usual time pressures. I witnessed various industry groups making comments, but I am not sure all of the smaller companies have been paying attention. Thus, I think we should begin looking at how this proposal will affect various companies. Will it be helpful? Expensive? Less expensive?

Outline of changes

UNDER PURPOSE, THE PROPOSAL mentions giving the requirements for a statement of actuarial opinion and memorandum. Formerly, it referred to guidelines and standards.

Under Scope, it allows the appointed actuary to use professional judgment in performing the asset analysis and developing the opinion and memorandum consistent with relevant ASOPs (Actuarial Standards of Practice). "However, the commissioner shall have the authority to specify specific methods of actuarial analysis and actuarial assumptions when, in his or her judgment, these specifications are necessary for an acceptable opinion...." A memorandum shall be required each year

Under Definitions, that for Asset Adequacy analysis removes the specific mention of various forms it may take. Thus, this is more general. In the Opinion, the reliance language has been modified to state that the actuary has reconciled the underlying basic asset and liability records to annual statement. At the discretion of the commissioner, language in the opinion referring to the adequacy of reserves in light of the assets may be omitted for single-state companies.

How This Might Affect Whom

NOTE THAT EVERY COMPANY (and fraternal society) must provide a memorandum annually. But what tests are required in the memorandum are left to professional discretion (subject to the actuarial standards of practice). This may save work. Let us say that a company uses cash flow testing for all or some of its business. Over a year, if conditions remain the same, it might be up to professional discretion to demonstrate that conditions are the same and refer to the previous year's study. This would probably save time and money overall.

Another problem is the commissioner can impose his/her own requirements on the appoint-ed actuary. One might tacitly assume that such requirements will be developed in a reasonable manner and will deal with innovative assets and liabilities. The open-ended language will allow the regulators to keep abreast of changing conditions. But it also allows the regulator to impose detailed conditions on smaller companies selling traditional products with traditional assets. Some fear the discretion.

If the proposal passes, every company will have to do some sort of analysis at least once. This would probably take the form of a gross premium valuation. Remember that ASOPs being developed would require this. ASOPs are not subject to state approval. Thus, the Academy will be able to set the details and the states (with input from the companies) will have no ability to limit this. This lack of limitation is what some fear.

In order to placate the concerns of the smaller companies, the one-state exemption was included. This means a company operating in a single state might obtain the consent of the commissioner to omit the memorandum. Many one-state companies exist. This includes some fraternals and some companies in the burial business as well. It also includes some substantial farm bureau companies and large fraternals in single states. Should single-state operations be the criterion for exemption? There are some companies in only a handful of states who would not be exempt.

The smaller insurance company Section members have learned over the years that their input is valuable. Prior to the December meeting, make your opinion known to Mark Peavy at the NAIC or to the management of your company.

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History of the small Policies

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while the small policy's progenitor is quickly disappearing, the small policy is still alive in the forms of ordinary life, final expense, and pre-need insurance, which do, and will for years to come, serve the needs of their policyholders.

As it was in 1875 before the Prudential introduced the small policy on a large scale in the United States, no criticism can diminish the value of small policies. The elderly and moderate/lower-income people need life insurance and are able to serve their needs with small policies. The history of small policies, which for a long time was the history of industrial insurance, has demonstrated that people of all means want life insurance, and people of lesser means need it most.

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