RECORD OF SOCIETY OF ACTUARIES
1991 VOL. 17 NO. 1

TERM INSURANCE DEVELOPMENTS

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Recorder: KIN K. GEE

- Effect of Guideline XXX
- Level term plans
- Preferred risk underwriting

MR. KIN K. GEE: I'm Kin Gee, managing director in worldwide insurance at Chase Manhattan Bank. Those of you who know me probably know that I like to collect oxymorons. Some of my favorite past ones were: Government worker, military intelligence, perhaps in New Orleans here, jumbo shrimp; one of my old titles, marketing actuary; and perhaps related to this topic is preferred smoker. I think I'll add another one here. As most of you know, baseball season has started. I'm from New York and follow the Mets. Our ace pitcher, Dwight Gooden, is in his last contract year, and right before opening day, his agents were trying to renegotiate his contract and basically trying to get a richer contract than this funny pitcher in Boston. He wasn't very successful initially, so they threatened that he'll just pitch out the season, and at the end of the season, turn into "a free agent."

Anyway, I think we're in for a treat. We have three very knowledgeable speakers on this product, and we're going to try to present from a different perspective. Our first speaker is Bill Schnaer who up until recently was with Millerco. He was the chief actuary and his final position was executive vice president research and development. As most of you probably know, Millerco is probably the biggest term writer, and I guess two or three years ago surpassed the Pru in terms of insurance in force. He's currently chief actuary and CFO of the Regan Holding Corporation in California. Bill is going to talk from the perspective of a stock company, primarily selling term as an alternative to whole life. Following that will be Armand de Palo who is vice president and chief actuary at the Guardian New York Domicile Mutual Company, who will from the perspective of the mutual company as well as give some comments on Guideline XXX and its implication and reserves for both stock and mutual companies. Last and certainly not least, Ron Colligan, who is not a member of the Society, but nevertheless tends to attend most of these meetings, and we accept him as an associate member, I guess. Ron is vice president of Regional Reinsurance Operation at Cologne Life Reinsurance. He's responsible for an operation over a 20-state region. Previously he was Vice President of Underwriting Research & Development at Transamerica Occidental Life. And he has over 21 years of underwriting, reinsurance and marketing experience. I present Bill Schnaer.

MR. WILLIAM J. SCHNAER: I'm going to talk about level term insurance, which is the only kind that my previous employer sold in any large numbers. First of all, I

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want to talk about term as an alternative to whole life. Perhaps to add to a list of Kin's oxymorons is what might be thought of as permanent term insurance. And I'll talk about pricing considerations, to a small extent, of global term insurance, not the obvious things but some of the things that have come up. And then I'd like to talk about compensation issues, which I think are important in any kind of insurance, especially if you're going to have a successful level term insurance operation.

When you think about term as an alternative to whole life, and I'm thinking primarily from the customer's standpoint, when does it make sense for someone to buy term insurance as an alternative to whole life? I think that you will hear impassioned speeches on both sides of the issue that term insurance is always and should always be the superior choice to cash-value life. Other people say term insurance is all right for a temporary need, but if you want something to cover you for the rest of your life, you need cash-value insurance and anything else is criminal. I'm not sure that the issue is so clear-cut. I think some of the issues that ought to be looked at are the purpose of the insurance, the tax efficiency of whatever financial arrangement the person is entering into, and the various expense levels.

I'll show you some comparisons based on what I consider average expense levels, but obviously from operation to operation they vary quite a bit, as does the investment expertise of whoever is going to be managing your finances. The question primarily revolves around having bought insurance, what is going to happen with the rest of your dollars over and above what is used for pure protection, and how many dollars you are going to end up with in 20, 30, 40 years, etc.

Speaking of the purpose of insurance, and this is by no means a complete list, just some things that come to the top of the head, they are: business reasons, deferred compensator, etc., estate liquidity, in which you would primarily find people in the twilight of life being interested, just a pure tax shelter purpose advantage of the tax-deferred aspects of life insurance, and instant estate. I think that my conversation is primarily focused on the last of these purposes. And if you're talking to a relatively young group, people in their 20s and 30s, perhaps even in their 40s, who have children at home, you must think about what is the purpose of buying insurance. Leave aside those needs that come in that are specialized, that perhaps have certain accounting advantages that have to do with estate liquidity. The kind of people that I was used to pricing for were people who weren't going to have to worry about business insurance. They were employees, and if the thought of being in an executive position where they could get deferred compensation was a dream of theirs, they were probably never going to realize it. They would be fortunate if they ever had an estate that would be taxable. To them the tax shelter aspect was more related to putting bread on the table. To them, the real problem is what if they died tomorrow. How is my family going to survive? Conversely, what if the nonworking spouse, which is becoming increasingly rare, were to die tomorrow? How are we going to survive? The purpose of their insurance was in case of dying too soon. Ostensibly, the theory is if you live long enough and are prudent and are like an ant instead of a grasshopper, you will accumulate enough money, or hopefully accumulate enough money, so that whoever you leave behind when you pass away can survive. Ultimately, if you live long enough, there will be no one left. You won't have anybody dependent upon you when you die. And I am a firm believer in the theory of decreasing needs. Someday as my children get older, I hope that, God willing,

when they get out of school and have jobs, they'll be in a position to support me instead of the other way around. So the real answer is what most people purchase, most of the insurance that's sold over the kitchen table and the insurance that the vast majority of Americans are buying, is the instant estate insurance. "I need money today, if God forbid I should get hit by a truck."

So let's look at the tax efficiency. One of the things that has to be looked at is the availability of a deductible IRA. At one time, anyone could do it, but now I think you have to be making less than $40,000 a year. But if you are, you have the ability to contribute money into an IRA on a pretax basis, which is a very powerful incentive. On the other hand, the availability in insurance and annuity products of deferring investment gains, that is, leaving aside the opportunity to invest in an IRA, is a very powerful consideration. And ultimately the inclusion of the term cost and the cost basis, if you have a combined contract, is also a tax consideration. So some of these are conflicting. You cannot use a life insurance contract as an IRA. So somebody has to sit down in their own personal situation and see which of these makes the most sense.

And then you have the expense level. I think it's fairly obvious, and the case has been made very powerful, starting many years ago, about why should you buy term and invest the difference. Basically, a term and an investment alternative has the lower expense level than whole life. I think it is for obvious reasons, and we'll get into that when we get into compensation issues. I have made the following assumptions based on my own experience. I have some interesting thoughts, and I did not choose these assumptions for any particular results. I chose them based on profit tests that I saw in trying to replicate various pricing.

I see a term plus an IRA, where there's an explicit expense load, an expense and profit load of 18% on the combination and a 1% spread on the invested assets. These are my assumptions. Term plus a non-IRA is 19%. And the only difference is that the mix of insurance and investment is different for the same after-tax cost when you have a nondeductible investment versus a deductible investment. And the interest spread is the same 1%.

Next is high commission Universal Life (UL), which I will mention, even though there are antirebating laws in 49 of the 50 states; we all know that rebating is here. And casualty life comes in all different flavors; the agent can pick and choose what he or she wants to sell – a high commission version based on what I've seen of an explicit expense load of about 11% in profit level, and a two-point spread. I know those of you who will say, "Show me a company who makes two points and I'll show you a company who isn't going to go bankrupt." But I think everybody prices to get a two-point spread. And the high commission UL or the low cash value has an explicit expense load in the 30s (I think it's 32% and a two-point spread on invested assets). Again, these are representative numbers. I think they're pretty reasonable.

And finally you have to think about the investment expertise. How well is somebody doing investing their own money versus giving it to an institution to invest – investment management companies versus life insurance companies? I think that's a very interesting consideration about the relative abilities of investment management companies, mutual funds, professional money managers, pension money managers,

etc. versus investment managers in life insurance companies. I think that the internal politics of life insurance companies often prevent their investment managers from attaining the same compensation levels that they could get on Wall Street. And so the question becomes if somebody can earn a seven-figure salary on Wall Street or a fourth of that much in a life insurance company, where are the better people likely to go? I think that life insurance companies need to examine their posture and realize that their competition in the investment management arena is not other life insurance companies, but it is the mutual funds who are paying much larger salaries.

And in terms of investment expertise, if a person is willing to take more risk, can they do better by investing in equity mutual funds and have the guarantees that life insurance companies provide? As we've seen very dramatically in the last year and in the last two weeks from the results of an insurance company trying to provide not only the competitive returns that can be attained through high-risk investments, but passing along the guarantees as well, it just can't be done. Something has to give.

I took a look at some various options in insurance savings and the results were very interesting to me. But as you might expect, certain alternatives all looking very much the same after the fact is not surprising, and the market forces will tend to make them so. What I have are five options. Regarding the after-tax accumulation, assuming a 20% tax rate of somebody putting $2,000 a year after-tax cost into a combination of insurance and savings. Now in this case, I've assumed a 12% gross rate, which is a little optimistic these days, but I don't think the relativity will change very much. Let's take an IRA at 11% assuming a one-point spread. Because you have more dollars working for you up front, it achieves a better picture than anything else, assuming identical gross investment returns. One of the things that is interesting is that the deferred non-IRA – think of it as an annuity earning 12, returning 11 – is virtually identical in after-tax efficiency and after-tax accumulations there is high cash-value UL. In this case, the lower expense level of the term plus annuity combination nondeductible annuity combination is offset by the ability to include the term cost in your cost basis of the high cash value UL.

The high-commission UL and a nondeferred fund – think of it as a term plus a mutual fund – again produce virtually the same result. Now this is a comparison looking at a lower income individual, someone who is eligible to deduct an IRA, which is why I used a 20% tax rate (Chart 1). And I think this is fascinating. It confirms that if somebody can take an IRA, given equal investment returns, they probably should. But that's given equal investment returns. What happens if your high-cash-value, universal life product can return a point more than your other alternatives? This may be the case if a person didn't want to take a very high risk and an insurance company could produce 100 basis points consistently more than a CD in a bank, which is often the choice for an IRA.

Interestingly enough, that 100 basis points, in other words, the UL high cash value at 11% instead of 10% (Chart 2), makes it virtually identical to the deductible IRA. Conversely the high-commission low-cash-value UL comes up to where it is neck and neck, just a tad behind at the later years, the term and annuity combination. And the term and mutual fund, if you have a nondeferred fund, comes lagging behind. Again, that's assuming that an insurance company in this case could produce 100 basis points better return over a number of years than the alternative.

CHART 1

OPTIONS IN INSURANCE & SAVINGS
Aftertax Accumulations @ 20% Tax Rate

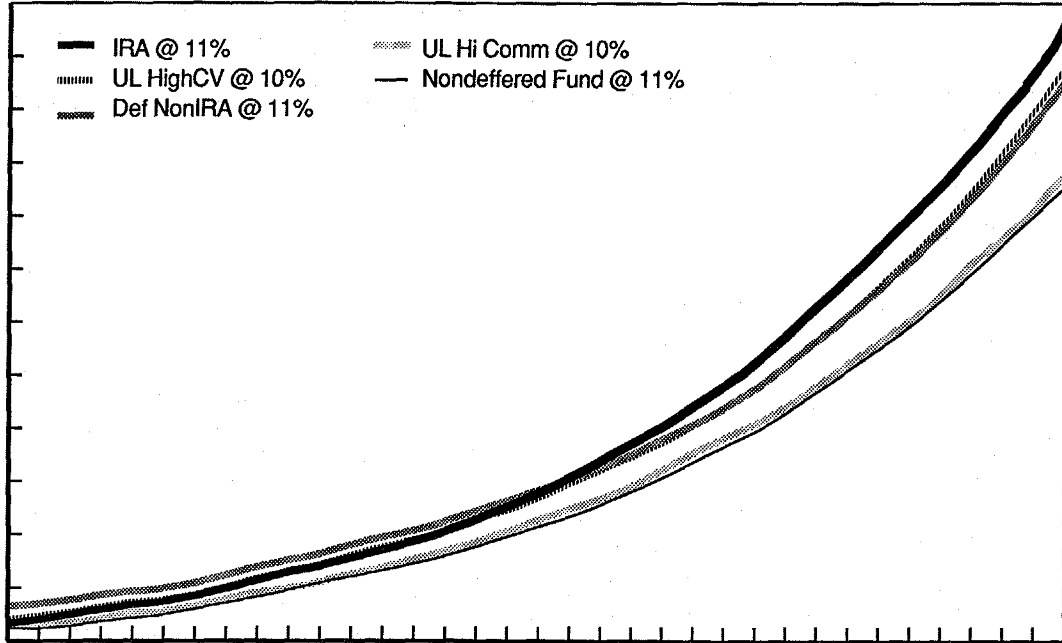
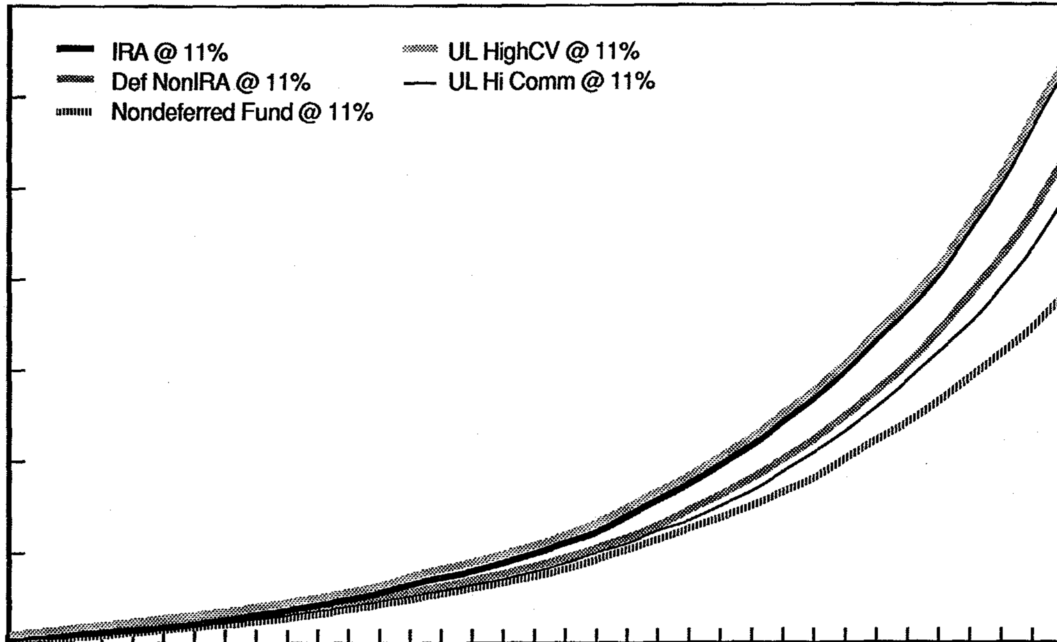


CHART 2

OPTIONS IN INSURANCE & SAVINGS
Aftertax Accumulations @ 20% Tax Rate



Let's move on, and at the risk of boring people to tears, let's look at a higher income individual, somebody at a 34% marginal tax rate. I've dropped the IRA alternative since that's not available to people in this tax bracket. Basically in this case, again, thinking of identical gross returns of 12%, the deferred fund and the high-cash-value UL are virtually identical (Chart 3). The high-commission UL falls behind, and then the term plus the nondeferred fund falls behind, showing the power of the tax situation. Obviously if the deferral of the inside buildup were taken away, if the ability to include the term cost, the cost of insurance (COI) charges as part of your cost basis were taken away, this picture would change completely.

Again, let's look at what happens if the insurance company earns one point more than the alternative, at which point the high-cash-value universal life becomes clear and away the best choice (Chart 4). And even with the low cash value, the high-commission UL becomes competitive with the alternative.

And finally, let us take the alternative situation (Chart 5), assuming, as I mentioned before, somebody is willing to take a higher degree of risk. It is not unreasonable to assume, given the experience over the last however many years you want to look at that a pool of equities should earn at least 300 basis points over the years over a pool of fixed income assets.

If you look at the period over the last 50-60 years, the spread has been significantly more than that. But then there are theoreticians who will tell you that interest rates were artificially low during that period. So I think trader basis points is a minimum. Then all of a sudden you find that the term plus the nondeferred fund becomes competitive with everything else.

The issue of tax efficiency and the issue of investment expertise offset one another very often. I still believe that, absent other things, for someone who can take advantage of an IRA it makes sense for them to buy term and do that, unless they firmly believe that they want the security of an insurance company versus the insecurity of an equity-based mutual fund. When it comes to a higher income individual, the situation is not clear at all. It depends on their willingness to take risk and their view of the ability of various pools of money during investment rates. I would say that, of course, would depend on the efficiency and the expense efficiency of whatever carrier you're looking at. If you were looking at a no-load mutual fund, that would really have an advantage over anything that I've shown here. Summarizing, I think term insurance as an alternative to whole life can make sense. I think that it can make sense to an individual from an emotional standpoint who wants more control over their own investments. It doesn't always produce the better or worse result. As with most things in life, it depends.

Moving on to pricing considerations, I think most of these are fairly obvious. I'm thinking of somebody who wants to sell level term insurance and make money on it. Demographics are very important. The administration is exceptionally important in the kind of market that we're talking about. And I think the sales presentation, how it's sold, is equally important. Demographics, in my opinion, are the primary determiner of persistency and mortality. Not everybody would agree with this, but I think that your customer group, who they are and where they live and their income levels, etc.,

OPTIONS IN INSURANCE & SAVINGS
Aftertax Accumulations @ 34% Tax Rate

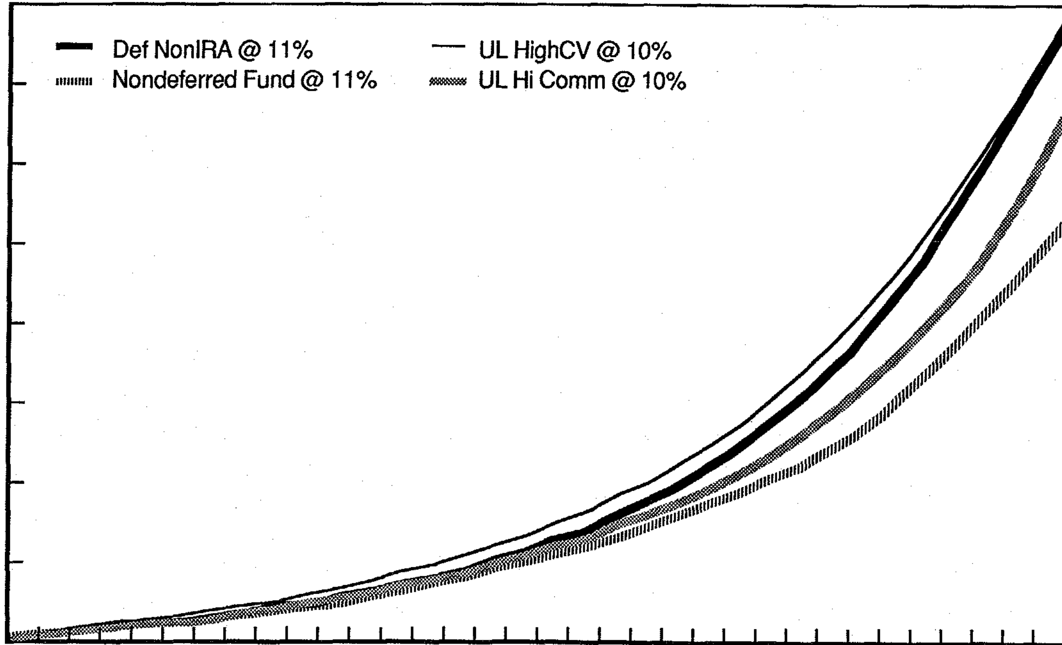


CHART 4

OPTIONS IN INSURANCE & SAVINGS
Aftertax Accumulations @ 34% Tax Rate

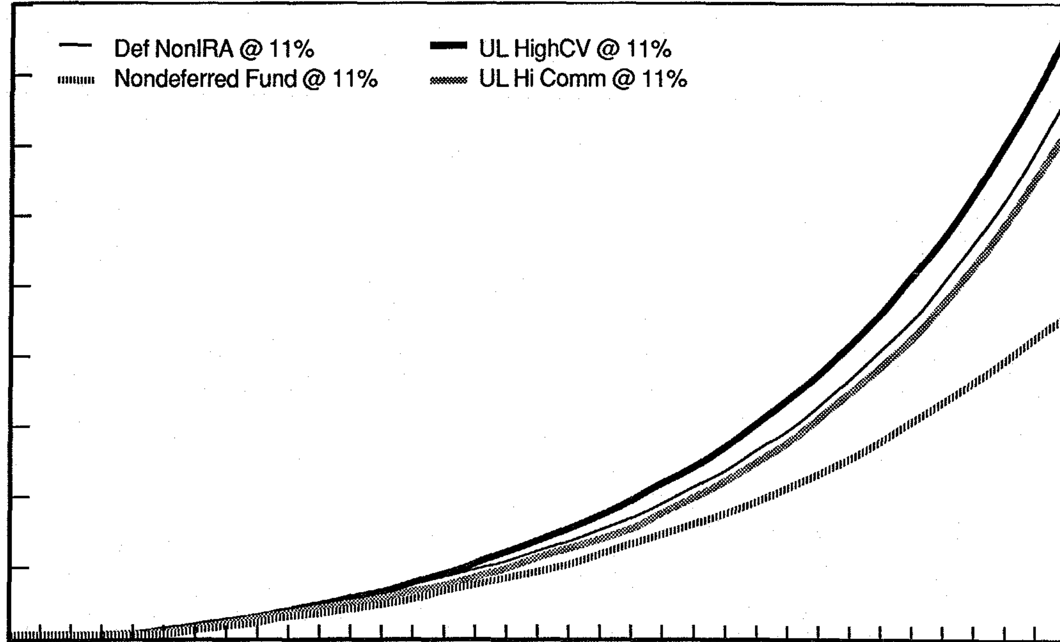
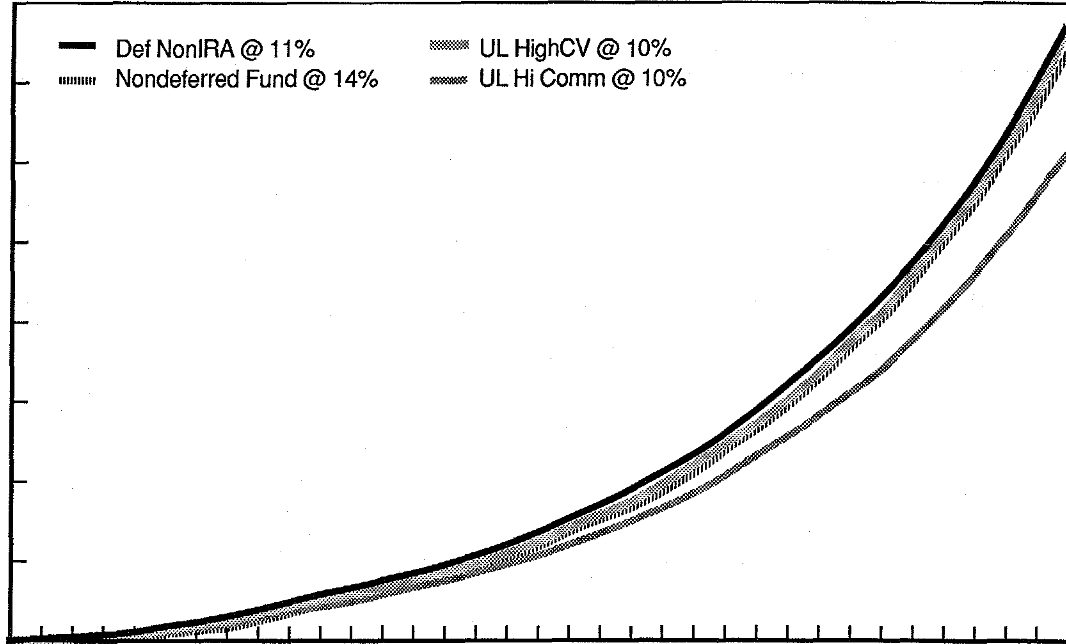


CHART 5

OPTIONS IN INSURANCE & SAVINGS
Aftertax Accumulations @ 34% Tax Rate



carry a built-in persistency and, to a great extent, a built-in mortality level. And it doesn't matter whether it's term or whole life, etc. The more affluent the market is, the better the chance that their persistence to mortality is likely to be absent (perhaps special situations such as reentry term). Millerco found that its persistency in its mortality was, given the amount of insurance they sold, very consistent with U.S. averages for, I would say, the lower-middle-class block of people.

Administration as I said, is vitally important. If you're selling to middle America, I would suggest that virtually the only way to keep your persistency up is to sell monthly preauthorized check/electronics fund transfer. I say most of us in this room live from paycheck to paycheck, and I think that's true for most Americans these days. If you bill someone quarterly or semiannually or annually, it is not clear that they're going to have the money available to pay. Therefore the best way to keep their insurance and their side investment in force, if they have one, is to hit them every month as their paycheck comes in. But in order to do that, given the mobil society, you have to be able to process address changes within 24 hours. You have to be able to process bank changes within 24 hours. My own experience as an insured is that it generally takes two or three months for the typical insurance company to process a bank change. I move frequently, and as I say, were it not for the fact that I understood how administrations work, I could have had policies lapse on me because insurance companies work two or three months behind me. And these were well-managed insurance companies. At Millerco they found that if they didn't process an address change within 24 hours, they stood a good chance of drafting an account that was closed. By the time they caught up, they had to draft a new account with two or even three months of premium. And as I said, most of us live from paycheck to paycheck. The money wasn't there and the policy lapsed.

Additionally, the premiums on level term insurance tend to be low. Millerco found that its average annual premium was in the neighborhood of $550-600. If you want to keep profits up and premiums reasonable, you have to keep extensions down. I would suggest obviously high automation; try to keep your staff down as much as possible. Use things such as voice-response, automated underwriting to the extent it's possible. A maintenance cost of $30 a year is probably the most that you can get away with and still have a reasonably competitive product.

I think the sales presentation is vitally important. And this will overlap into compensation issues. If term insurance, in my opinion, is going to be sold successfully as an alternative to whole life, not as a temporary need, it has to be a salesperson's primary product. Otherwise it is sold only to those people who are shopping, only those people who either can't afford what it is they are going to buy and therefore have a much greater risk of lapse because of lack of funds, or who are just buying a policy until the next person comes along with a cheaper product and will jump ship. I think it would be very difficult to convince a salesperson to give up selling whole life insurance at the higher commission levels, higher premium levels, to sell a term plus a fund combination at a much lower commission level, unless that were the only thing that he or she had to sell.

Compensation issues: Why has no one, except for my former employer, made a huge success of a term insurance sales force, term-insurance-only sales force in the middle market? There have been other companies who have tried it and failed. I

think one of the issues is part time. I think that it would be virtually impossible for a full-time salesperson to make enough income to support him or herself selling nothing but term insurance. The commissions aren't there. You need a part-time sales force. It doesn't mean they have to be part-time insurance people. Large casualty companies with a life affiliate could handle that. But you need someone with another source of income in order to be able to sell that. It's difficult to have.

Information costs money to disseminate. It's a justification for paying commissions. The Millerco sales force is compensated more heavily than other salespeople for selling term insurance, partly because they need to live and partly because they need to pay people extra to bring the information and spend time convincing people that term insurance is the thing to do.

Rebating, I mentioned, is one of my pet peeves. I think that the antirebating laws should be abolished for all intents and purposes. Companies selling cash-value insurance have agents who are rebating. You have low-commission riders, high-commission riders, low-cash values, high-cash values. You can mix and match them. Basically an agent can pick whatever combination of commission and cash value that he or she wants to give the customer, and it's there. It's only when companies have something plain vanilla like a term insurance policy that they're not allowed to rebate. I think the only people who could benefit are the American consumer. Everybody else who is saying that rebating is terrible and shouldn't be allowed is already doing it.

And finally, this is just a general compensation issue: the price of success. If you have a successful sales force and you have someone making a lot of money, how do you keep them motivated? It's one of the problems of being too successful. One of the issues that I think all of us confront with our agents is when somebody is very successful, builds up a lot of renewals and has a lot of money coming in. How do you keep your best people from doing what they do best, which is recruiting and selling more insurance?

MR. ARMAND M. DE PALO: Term insurance is no longer simple. You can't really just look at the going-in premium and know what you have. The large number of flavors, varieties, reentry provisions, conversion provisions, and guarantees are all over the place, and you need to really see how complicated it is. It's not just the premiums. You begin seeing that compensation starts entering in where the premium is.

Now I'm going to speak on the subject of term insurance from how a mutual company with a career field force views some of the products on the market today. Obviously every company has to view things from the situation that they're all in, so many of the things I will say are not how the companies from a stock brokerage firm may view the exact same situation. And I expect that each side would have different commentary. At the end I'm open to any questions.

Low-priced term insurance has continued to exist in the market today, even though it's no longer helped by the very favorable reinsurance or tax incentives that we saw in the early 1980s. The graded-premium or reentry-term-premium product no longer exists. Really where the market has turned is to variations of level premium insurance that still have reentry, but are at a level premium for a period of years.

Term products are sold both by mutual companies with career systems as well as brokerage companies. However, the traditional marketing view of most career mutual companies differs from that of the brokerage companies, resulting in different product designs. Most mutual companies try to explain to their career agents that it is impossible for them to sell a product at the same rate as certain low-cost brokerage companies sell their term products and still be profitable. In addition, many mutual companies do not believe the brokerage companies will ultimately be profitable on these products. I agree and will explain why this may be true.

Brokerage companies sell term insurance for many reasons. Since they have low-cost agencies, the term product can be priced more inexpensively, but maybe not as much as the current difference in premium would warrant. They need to have a product to sell in order to keep the relationship with their brokerage agents going. Since the term market is a price-driven market, the quality and rating of a company are far less important. For some brokerage companies, term may be priced on a marginal expense basis or actually be a loss leader in order to sell other products through the agent relationships that they have established. Brokerage companies may actually expect a product to be profitable. Since many of these products are level premium products, the company may not be holding what many actuaries believe would be proper reserves, creating sizeable early duration profits.

What is the result? Later policy duration claim costs may be higher than the premium, and without proper reserves, losses may occur. High lapse rates may help some companies, but may actually hurt others if only the unhealthy lives remain. Even if the policy can be kept in force at the higher premium rates, primarily the less healthy lives will remain in force and rates may prove ultimately to be inadequate.

Since most brokerage term products are priced in the select period of the mortality curve, the initial rates are relatively lower than the typical attained-age product of most mutual companies. As a result, many career agents who need low-cost term insurance will go to the brokerage companies. This causes a problem for the career distribution system, because the agent who wants to convert the policy cannot convert that term policy back to his primary company.

The mutual company term product is designed differently than the typical brokerage contract. In general, it offers long-term conversion privileges and tends to be renewable over very long periods of time such as to age 70 or to age 100. In addition, the mutual company product is usually an attained-age product. All insureds remain part of a single class, and less healthy lives do not pay a higher premium rate. All of these features result in a product that has a higher initial premium.

If you compare term insurance rates of typical brokerage companies with the rates of a mutual company's attained age YRT product, the brokerage products become very complex after the first guarantee period and cost of coverage can vary widely, depending on the health of the insured.

In addition, the career agent of a mutual company also receives social security payments, pension, health, dental, disability, life insurance, training, and housing that are not borne by the brokerage companies. The problem is that the agent wants all of these valuable benefits as well as a product that is priced at the same level as the

one the brokerage company is selling. However, the initial rate of a typical mutual company YRT product is at about the same level as the guarantee rate of many of the 10-year term products being offered by the brokerage companies.

To make the competition even worse, the brokerage companies guarantee the 10-year rate for the entire 10-year period. The mutual company does not guarantee the YRT rate for much more than one to three years, although a few have guaranteed it for as long as five. These rate guarantees should produce sizeable deficiency reserves, but some companies are very aggressive in holding reserves. By "aggressive," I refer to holding reserves that some actuaries may view as being less than would be required in their interpretation of the law.

If the result was only a few small brokerage companies that would ultimately lose money, most companies would not care. However, several of these companies are selling very large volumes of term. If profit problems develop, these companies could become insolvent, thereby causing their losses to be passed on to other companies that would be assessed by the Guaranty Associations. The mutual companies, in effect, lose the sale and they ultimately pay for some of the brokerage losses.

The regulators may have to be concerned that the reserves held by some of these brokerage companies are not consistent with what many actuaries believe are consistent or proper reserves. Most likely, the reserves currently held will prove to be inadequate at later durations. It is my opinion that these companies should retroactively be required to hold a more adequate reserve. However, as many of them have stated, their companies would be insolvent if they were required to do this.

The NAIC is planning to come up with a reserve standard currently labeled, "Guideline XXX." A committee of companies formed a joint ACLI/NALC task force to review the original NAIC proposal and to make suggestions. This committee was formed mostly by companies currently holding these lower levels of reserves. This committee's membership was then closed. Others who attended their meetings could not vote on the proposal. Simply stated, these companies still do not want to hold higher reserves and are willing to fight for it under the flag of consumerism. However, reserves do not create profits; they only affect the timing of earnings. And many of these companies that are growing very rapidly could be facing very serious problems in the future.

I believe the Guideline XXX Proposal as it is currently presented has some serious flaws. The use of select mortality factors for reserves is optional. In effect, a company can use ultimate mortality factors for basic reserves and hold much lower reserves than presented. This is an important feature. All of the presentation done under Guideline XXX is predicated on the use of select and ultimate factors for a 10-year term product that does produce sizable base plan reserves. But the proposal makes it optional to use it. So any company desiring not to hold those higher reserves can simply revert to using the ultimate table and, therefore, hold much lower reserves. These higher reserves are what the committee then presented as the reason why the reserves were adequate.

The reserves are affected by how a company varies its gross premium by creating what is called in the regulation "segments." Terminal reserves are always zero at the

end of each segment. In effect, no prefunding of any problem in later segments occurs. As an example, if you have deficiency reserves in the future, by producing a segment and having a terminal reserve, you do not have to face the funding of that deficiency reserve until you get to the segment that the deficiency exists in.

Deficiency reserves are determined from a much lower mortality table that has little or no provision for expenses, antiselection, or variation in mortality between companies. The companies can also define short segments to eliminate whatever deficiency remains after using this lower table. In addition to the safe harbor table being used, which is already too low, a still lower table can be used if you have a preferred class of risk. Clearly, on an industry-wide basis, these tables will not prove to be adequate for the majority of companies.

More importantly, the brokerage companies are suggesting that their products be handled differently. If change to a gross premium valuation method is needed, all policies and reserves need to be reviewed, not just term insurance. We should not base change on just those reserves of the companies who are having problems and do not wish to hold what some of you consider proper or adequate reserves.

In conclusion, there are some term brokerage companies that are selling term products at very low premiums. These brokerage companies are able to undersell mutual companies because of their lower agent expenses and the lower reserves that they are holding that many actuaries may deem inadequate. Guideline XXX may affect the brokerage marketplace if it can require all insurance companies to hold more proper and consistent reserves that may be higher than those that are currently being held by some companies. Clearly, these higher reserves will reduce the early statutory profits now being reported by many of these brokerage companies which are currently using aggressive reserves. If this business is truly profitable, these companies should be more than able to find reinsurers who are willing to finance this strain for them without subjecting the industry to a lower reserve standard.

A lot of other things are changing in the term market. For example, on larger amounts of insurance, the company has flattened out compensation. The initial rate is very low on the term insurance, and sometimes you'll see an odd feature like a 10-year level term product from an aggressive company that can actually have a lower premium than a five-year term product. So you really have to look at all of the products in the marketplace and see what happens after the first guarantee period to really get a good feel for where the term market is.

Compare a wide number of companies over a longer period of time through a guarantee period, with reentry, and then without reentry (if you're not eligible for it). You'll find that if you become unhealthy, the ultimate cost of being on a term product that has a reentry and a higher scale of rates (if you don't reenter) can actually prove to be far more expensive than the term product that's being sold by the typical mutual company, which is an attained-age premium product where the rates do not change and the person stays in the same class for the duration of the policy.

MR. RONALD A. COLLIGAN: You can rest assured, now that Kin has made me an Associate of the Society of Actuaries, I'm going to go back to Connecticut and I'm going to ask for a pay raise and some study time.

My basic training is as an underwriter. One of my colleagues at Cologne whose basic training was in actuarial science came back from a trip a few weeks ago with a story that he said I really ought to relate to you during my presentation. It was a story about an underwriter and an actuary who were traveling to a meeting in a city that was 200 miles away from their home base. They didn't want to fly, but they didn't want to drive, so they took the train. They're seated together on the train, and as they're going through the countryside, they're talking about insurance and a lot of different things. They get bored and decide to play a little game of chance. The underwriter says to the actuary, "Look, actuaries are really smart people and underwriters sometimes aren't that smart. We have to have some odds in this thing if it's going to be fair. We're going to play a game with riddles, and the odds are going to be 2-1 if it's okay with you. Every time I give you a riddle that you don't know the answer to, you've got to give me $100. Every time I don't know the answer, I've got to give you $50." And the actuary sits and he's thinking a little bit and he says, "Well, I've got to be at least twice as smart as this guy -- I've got my FSA. I'll take those odds." So they start playing, and the underwriter says, "Okay, I go first. What has two legs when it sits, and four legs when it stands?" And the actuary scratches his head and thinks for a minute or so and hands him a hundred dollar bill and says, "I don't know. Here's a hundred." The underwriter says, "I don't know either. Here's fifty." One time an underwriter got the best of an actuary.

Last year when I participated in this meeting, it was as vice president underwriting research & development of Transamerica Life in Los Angeles. This year, it's as vice president regional reinsurance operations at Cologne Re. Last year in this forum, I spoke on reinsurance from the ceding company's perspective and this year I'm speaking on developments in the term marketplace from the reinsurer's point of view. Actually, I'll be concentrating most of my comments on this subject from the underwriting perspective.

As you all know, mortality is such a significant component in the term equation that when product design is considered, underwriting has got to be factored into everything that you as actuaries do for corporate profits to be fully appreciated. To understand the state of the reinsurance market relative to the term insurance business today, we must go back eight or ten years ago to the early and mid-1980s. Many reinsurers had generated enormous profits from their participation in MODCO 820. Many reinsurers were taking advantage of Section 818C in their pricing. Volume competition had heated up. Several large mutual companies had entered the retrocession market, bringing perhaps an additional $20 million in capacity to that marketplace which needed to be filled. Mortality from coronary artery disease was dropping rapidly and was expected to continue to drop. As we all know, these factors coincided with the development of the reentry, select-and-ultimate term concept, a concept that we just heard a little bit about.

What a bonanza for reinsurers and primary companies too, who were looking for a quick fix in volume growth. Most reinsurers were happy to provide the coinsurance allowances, pick up the deficiency reserves and liberalize both underwriting requirements and standards to assist primary companies in putting on their books perhaps the largest volume of underpriced, liberally underwritten business in history.

Surprise, surprise. Most of the reinsurers and the primary industry lost money on these blocks of business. Lives which continued in good health rolled over a number of times during this period, and neither ceding company nor reinsurers had much chance at all to make a profit. One thing that comes to mind when I look back on those days is the fact that many reinsurers lost a lot more money than they recognized when a case rolled over. On an automatic situation, when a reinsurer was bound by a client company with whom they had a select-and-ultimate term agreement they would retrocede amounts over their retention and they would pay money on these retrocession cases. When a case rolled over, all of you know that a lapse notice comes into reinsurers over a much longer period of time than does a new cession.

So Reinsurer A who had a piece of select-and-ultimate term business from Company B who retained $500,000 and retroceded $500,000 on it, when another cession came in from Company C who had just replaced Company B for a million dollars, retroceded that whole amount and then six months later found out that they had bought too much retrocessional cover. The reinsurance industry was in a state of total disaster based on select-and-ultimate term persistency. We all got out of it.

Last year at this session in Hartford, I made an appeal as a primary company officer to the reinsurance community to help rehabilitate large blocks of still existing select-and-ultimate term business. I'm still, as a reinsurer, asking that reinsurers all get together and help those companies that do have some problems with these remaining books to try and get the products, perhaps on an exchange or conversion basis, to be a little bit more profitable for all of us concerned.

Okay, enough about what used to be. What's the term marketplace like currently? How is it better? How is it worse? How is it going to get in the future? Again, I'd like to concentrate my remarks primarily in the underwriting area. I'd like to speak somewhat about the financial antiselection that we see in the term marketplace, and it's there whether we recognize it or not. We need to be cognizant that, in a pure mortality environment, risk selection is of paramount importance. There is an ever-increasing prevalence and scope of preferred underwriting criteria and the critical need to have underwriters involved in the product development process. Remember when I'm speaking that I'm wearing many different hats. I'm wearing the hat primarily as a reinsurance profit center manager. I have responsibility for actuarial pricing, marketing, underwriting and administration for 20 states, as Kin said in his introduction. I'm also speaking as an advocate for my clients: the direct writing companies. I believe very strongly that any good reinsurance person is not only the representative of the company to its clients, but also the client's representative to the company. It's important for all of us in the reinsurance business to know exactly what's going on in the primary side if we're going to help you with capacity and underwriting. Remember also that I'm speaking with 18 years of underwriting experience; you can take the boy out of underwriting but you can't take the underwriting out of the boy.

With this perspective then, how do I see the current term market? I can sum up my feelings in one word: disjointed. What's surprising to many of us in the reinsurance business today is that we, as reinsurers, seem to be on the edge of another market share coinsurance war in an attempt to put term volume on the books as we were

back in the 1980s. Why are we doing this? Is it in large measure because we reversed, to a degree, the mortality and persistency loses we suffered in the 1980s? Are we attempting to replace reinsurance premium lost in the marketplace due to the restructuring of the reinsurance arrangements of the former largest buyer of reinsurance? Are we thinking that the recent years of good mortality mean continued improvement in that area? Let's take a look at what's happened in that area.

I'm going to talk about preferred products and blood profile and AIDS and other tests a little bit later on. But one of my feelings is that a large degree of improvement in the term marketplace, as far as mortality in the last few years goes, has been due to the fact that we've been blood testing individuals at amounts we never thought of in the old SMA12 days. We started doing it because of HIV infection. In my mind, in the last four or five years, we've reaped a bonanza in decreased trauma deaths because of the ancillary information that we've gotten on blood, primarily liver function studies. We've also been getting urinalyses at lower levels where we're screening for cocaine. That's helped us out in the trauma death area also. We seem to be though (at the behest of a lot of labs that are now as prevalent as reinsurers trying to sell you on a select-and-ultimate term product 10 years ago) developing new technologies to screen for HIV infection. Those technologies are naturally the urine method and now the saliva method or the transmucosul exudate technically correct method that's being used.

What are we giving up? We're giving up what, in my mind, has been very causal of our decreased trauma mortality in the last three to five years, and that would be the liver function studies where we have an individual that underwriters are going to say, "Gee, this guy is not going to die of cirrhosis. This guy is more prone than the normal applicant to fly his plane into a mountain or to drive his car into a tree." I would appeal to you, if you have built mortality adjustments into your products because of blood that we've gotten – and it's not only for trauma; it's for coronary artery risk factors with lipids also – to really think hard before you go to another method of HIV collection, because we are giving up something very significant when we give up the blood.

I'm also concerned that we seem to see some companies going to agent collection of specimens other than blood when we're moving to saliva and urine testing. Now, I think we've got to be very, very careful and analyze what we think might be some extra mortality in conjunction with the definite cost savings that we've got there, because we're not going to spend $50 for a paramedic to collect a specimen. But I do think if we have one bad agent, we can have a significant problem with HIV-positive people having substitution on that. So think about that a little bit. We will talk more about that later.

Another factor in reinsurance competition is that we see reductions and expenses due to the restructuring and staff adjustment processes of the late 1980s affecting reinsurance pricing. Will our expectations of higher margins on this business occur? Maybe, maybe not. It must be said, however, that competition in the primary marketplace is fierce also. And quite naturally, this has caused pressure on the reinsurance community for ever-increasing allowances.

Perhaps the most significant development in the term marketplace is the ever-increasing number and complexity of preferred products available. I'd like to speak about preferred underwriting classification and the potential for both bad and good that it brings to our business. Let's analyze for a minute what the intent of the preferred risk product is. It is as we all recognize, to create a grade of risk which we can price lower in an attempt to sell more business. We also have, by doing this naturally, created a higher grade of risk for which we must charge an increased premium. The most important thing in developing a preferred risk product is to get those two in sync, to make sure that your underwriters know that you priced for 40% preferred, and if they push 60% of the population into that preferred class, your mortality is going to be skewed. The underwriter has to be intimately involved in knowing what percentage of people you are pricing to be in the preferred class, so they can try and set the criteria for inclusion in the preferred class in sync with that.

Preferred risk underwriting has caused two major problems. You might not think the first is a problem because of preferred risk underwriting, but I do. It's proposal selling. Let's face it. Proposals and illustrations are what, for the most part, sell policies today. We have all seen the "Quotesmith Ads" in *The Wall Street Journal* and other ads that offer instant computer proposals. I'm certain most of our companies are doing business on a proposal basis. A good number of proposals for a client's consideration sell a policy in a competitive term marketplace. Let's not think for a minute that these, and the proposals provided by most of the producers we deal with, are not based on preferred classification if a company has a preferred classification. It follows then that, if the industry average is 60% or so of clients qualifying for preferred, and if we fail to divulge this on the proposal, we may be accused of misleading the public.

This fact was made very clear to me last year. It was during an interview with *The Wall Street Journal* on preferred products. I was sitting in an office with three other people, one being a public relations person, and it was a telephone call interview from New York. Naturally the reporter was pushing and pushing and pushing. We started talking about preferred products, and we started talking about illustration selling. And the reporter pushed and pushed and pushed until one of the people in the room made the comment that it could be considered to be like "bait and switch." As soon as it was said, everybody put their head down, and the public relations guy started choking himself. But quite frankly, this was published. And I think this is something that the industry is going to get in trouble over. The regulators are going to look at this, and we're going to be increasingly regulatory-sensitive because of what's happened down on the West Coast recently. If we continue to provide proposals indicating a premium level that is going to be actually delivered to only 60% of our clientele, without divulging this, I think we may have some problems.

The second problem with preferred class is that we seem to be fractionalizing the insurance population into groups that are going to be unmanageable. You have lifestyle underwriting. You have medical preferred. You have preferred smokers, as we refer to. We have for example, nonsmoker policies where you can qualify for preferred if you don't use any tobacco, but you can't qualify for preferred if you smoke a pipe, a cigar or chew tobacco. You can qualify for standard nonsmoker on that basis. Well surprise, surprise. Everybody who comes in that applies for preferred and has nicotine in the urine, tell us they smoke a pipe or they chew tobacco. In

fact, I found in one situation in one study that 60% of the corporate executives in America were chewing tobacco. And I think we've got to be very, very careful if we set up preferred criteria where there is some way of getting around the smoking classification, because we're going to be selected against and have some extra mortality. I'd advise everyone that has a product where a cigar smoker, pipe smoker or some user of tobacco other than cigarettes can qualify for a nonsmoker policy, but can't qualify for a preferred policy, to do an analysis. Because I'll bet you that your standard nonsmoker class is comprised almost exclusively of cigarette smokers who are not telling the truth. The reason you find it out is because most of these people come in with nicotine in the urine and only then do we find out that they smoke a pipe. Well, if you show up with a large amount of cotenine or nicotine in the urine and you say you smoke a pipe or cigar, the only way you're going to get that amount of cotenine in the urine is if you're inhaling. And if you're inhaling it, your mortality is more akin to a cigarette smoker than it is to a pipe smoker.

One of the things I think is most important, and all important in some situations, to preferred risk underwriting is lifestyle underwriting. We've seen some very significant declines in mortality when people recognize that, on term insurance, rich people die quickly because they live their lives dangerously. What you need to look at is motor vehicle reports. You need to look at the GGTs and some of the other liver function studies involved in the blood profile in the SMA12. You particularly need to look at aviation. I think any company that does a mortality study on aviation and looks just at the number of people in their aviation pool that have died in plane crashes is not looking at the whole picture. We tend to find that people that fly have very high rates of trauma death from all accidental death causes, not just aviation. I did a study to try and find some way of issuing any aviation, private aviation case standard a few years ago, and could not find any justification for it primarily because aviators had more car accidents, they had more mountain-climbing accidents, etc. People that tend to fly also tend to do other things in their lifestyles that might be predictive of extra mortality.

I want to talk a little bit about two other things and I know we want some time for questions and answers. There are two other things that I think are going to be significant in the preferred risk underwriting categories. We are now finding that laboratories are taking advantage of some very recent technology that is developing within the clinical community and the research community to do two things. The number one thing is perhaps the least dramatic, and that's a further fractionalization of liver function, of the GGT, which is something that all underwriters look at as an indication of free social alcohol use. And they've developed a test that's going to be announced fairly soon called DST which is another liver enzyme that is almost exclusively elevated by alcohol use. And what it's going to allow underwriters to do is take the individual who's had the elevated GGT and run this other test to determine whether or not this GGT is actually related to alcohol use. It's going to allow us to take some individual's standard, whom we might otherwise rate, but it's going to make our underwriting a little bit more selective when it comes to preferred risk, and I think this is good.

The second thing, and I think this is probably going to be the most interesting thing as far as preferred risk underwriting, are tumor markers. We've been seeing some labs push a number of tumor markers, primarily PSA or prostate specific antigen, for

about a year now. What that is is a marker that's been developed by the clinical community to trace the progress of prostate cancer in people that are known to have had it. It's an antigen that's very elevated in individuals that have prostate cancer. It's been thought that as a screening device in the insurance industry that we can perhaps use it in males over age 70 for amounts over $500,000 or something like that, and the cost effectiveness will be fairly good. The thing that's the most exciting though now is that there seems to be in development and probably ready to be announced very shortly, and it has been announced to a lot of companies and I've gotten permission of some people to chat about this, a very generalized tumor marker that will perhaps, three to five years before clinical manifestation, be able to determine individuals who might be developing a malignant disease process.

This is extremely important to us. If we look at our mortality for malignant disease, we'll find an adverse proportion of death claims 18 months to five years after policy issue. And in my mind, we're dealing with antiselection of an individual that just doesn't feel right. They say, "I know there's something wrong with me. I don't know what it is." They'll buy a lot of insurance, and then go to the doctor later on. I think if all of you take a look at your blocks of malignant disease claims, you're going to find this is the case. Interestingly enough, in the reinsurance arena, you can find a higher proportion of cancer claims, that is, early cancer claims in your automatic portfolio than you do in your facultative portfolio. Naturally in your facultative portfolio, the case is being sent to you for some reason. You know there's a medical problem on it. In the automatic portfolio, it's generally standard and you share in the same type of antiselection that we were talking about before. This test is going to be something that I think might change the face of underwriting for preferred products. Malignant disease is a major component of what we do.

I'd like to encourage all of you to speak to your underwriters about what they can offer you in your pricing for preferred products, especially on your term business. I'd like to encourage you to think about lifestyle underwriting, to think about trauma deaths, and to recognize that, on term insurance, the trauma death component of mortality is probably much higher than on your permanent business. As an underwriter, I want to encourage all of you again to get your underwriters heavily involved in the product development process. If we are going to survive as an industry, we need to work closely together to make certain that the margins that seem to be ever decreasing can come back up to the point where we can all make some money.

MR. GEE: I just want to make one comment on Bill Schnaer's presentation. I'm sure, for pricing and market development, there's always intense pressure to sort of shave the rates and bring the rates down, as well as look at some structure or look at seven-year term, 10-year term. But basically there's a lot of pressure on price-per-thousand per-unit type basis. I noticed that at Millerco, if you look at their products relative to many of the other products available on the street, they were not necessarily the lowest price or lowest cost product. And yet they have produced more term than the Pru. Something to keep in mind when you look at product development and so on is it's not necessarily price but the ability to package sales technique that counts. I think that's one of the reasons why Bill went toward the other programs he's talking about, term as an alternative to whole life. Now I'll open up the floor to questions.

PANEL DISCUSSION

MR. P. ANDREW WARE: Bill, I'd like to take issue with your proposal that it takes a company agent who primarily emphasizes term insurance to be able to sell it successfully. Certainly Northwestern doesn't emphasize term insurance, although we sell more term insurance by face amount than whole life. And we don't suffer the bad effects of high lapses and so forth that you were alluding to. Another thing is I think you forgot to mention a life insurance product that invests its cash values in equities. It would probably look pretty good too.

Mr. de Palo, one of your concerns with the task force report on term insurance reserves was that future deficiencies in future segments weren't accounted for. I believe that was a flaw with the report that will be corrected for the next one.

One of the things that I was disappointed with when the ACLI exposed that report was that there were so few comments. It's still open for comment and has been open for about four months. I would urge everyone here who is interested in term and term reserves to look at that report and submit your comments to the NAIC. I think they need more input from the industry.

MR. DE PALO: Andy, I just want to make one comment. I think the issue is much broader than term insurance. I think that's what I'm really saying. It may be time for the industry to seriously look at gross premium reserves as an alternative to just blindly going with the net premium reserves that have been used in this industry for virtually 100 years. But it's an issue that's so broad and so far-reaching that a small product line should not be segmented for special treatment. If the day has come that we need to do it, then all the valuation actuaries and professionals of this industry have to get together and find a uniform reserve theory that we want to bring out, and not come to market saying, "Here's a bunch of companies that have chosen to be aggressive." And you could use your own interpretation of what the word aggressive means. If these aggressive companies had to stand up to the current procedures that other companies consider the norm, they would currently be insolvent, so shouldn't we do something to help them? That's the question that's on the table. If their current level of reserves is excessive, yes, they should be reviewed and an appropriate level should be set. But to do it because a company says, "We don't want to do it and we're not willing to make a change in our posture and agree with what we're doing instead of agree with the rest of the industry," is causing a tear. And if a company has a narrow portfolio of one product and writes a tremendous amount of it on the basis where reserves may prove to be inadequate, they're going to hurt the balance of the industry. And that's what the concern here is.

MR. GEE: Bill, do you want to comment a bit on the first question?

MR. SCHNAER: I didn't feel I necessarily excluded variable universal life. I believe it's difficult to find. To me, again, the universal life invested in equities with a better return is being included on the return. Northwestern Mutual sells to a very sophisticated buyer group. I'm not familiar with its experience. If you are selling term insurance with successful persistency, I congratulate you. There's a conflict if a person actually thought that, in a specific instance, term insurance would be better for a client. To sell a lower commissioned package, I think, presents a serious conflict to somebody.

MR. W. KEITH SLOAN: I'm a consultant with Bryan Pendleton Swats & McAllister. I'm also one of those people that you can't take the underwriter out of because I first became an underwriter in 1952. At that time, there was a big push for preferred risk underwriting. A few years later, Home Office Life Underwriters Association (HOLUA) and the institute both said, "The only thing that we could find that makes any difference is that the preferred risk policies are for larger amounts and you save expenses." This may be changing now that we do have some better clinical testing available. But I would like to urge everybody to take with a grain of salt the results you're likely to get when your underwriter gets enthusiastic about going for a preferred risk.

On the term, some people will be unhappy with me, and I'm not going to express all that I have said under the heading "term use protectatus and contingency." But I think that the key to both the presentation and the comment before is that the purpose of the insurance is essential. It must be sold for a purpose, and that's how Northwestern agents sell a lot of term insurance. I've sold term insurance. I bought term insurance. I've outlived it.

On the subject of the reserves, I think the place to address that is the Actuarial Standards Board (ASB) because it's virtually impossible to get everything into the valuation law that's needed, which is why in 1974 I started pushing the NAIC for the valuation actuary concept. And the valuation actuary must take such things into account.

MR. DE PALO: A comment on that. I've been talking to Harold Ingraham about getting the ASB involved. I agree with you wholeheartedly. It has to be an industry-wide approach.

MR. WILBUR M. BOLTON: I would strongly take issue with Mr. de Palo's comments about the nature of the task force assembled by the industry, an ACLI/NALC task force. The 15 members on the task force included several members from mutual companies. In addition, observers from other companies, not represented officially on the task force, also attended a number of task force meetings.

In this regard, I am astonished at Mr. de Palo's comments about the lack of representation of the task force. I am trying to ascertain whether the Guardian in fact has an official view on this matter. Mr. Thomas Kabele, with the Guardian, sat in on several of our meetings. We were under the impression that Mr. Kabele, to the extent that he was not a "free agent" in the ideas which he expressed, was representing the Guardian viewpoint. And Mr. de Palo seems to be at some odds with that.

MR. DE PALO: I'm not at odds with that at all. I wish you would reflect some of Mr. Kabele's comments.

MR. BOLTON: Some of Mr. Kabele's comments or concepts were reflected in the report, and Mr. Kabele is perfectly willing to volunteer comments on his own. He doesn't have to be asked. But I would urge those (Society) members further interested in this issue to obtain a copy of the task force report, attached to American Council Bulletin No. 4310, dated December 21, 1990.

And I'll second Mr. Ware's suggestion to please examine this proposal, and determine what might be the strong or the weak points. The comment period is still open. The NAIC has not taken any position on it. Eventually some guidelines will be drafted. We will attempt to correct for any weaknesses that are brought out. I could offer some points to counter Mr. de Palo's comments, but it is enough to encourage members to read the report and consider the possibilities, both strengths and weaknesses.

MR. DE PALO: My only comment is the whole goal of anything of this magnitude, and changing a reserve standard is really of enormous magnitude, has to involve a tremendous across-the-board review of all actuaries. There's going to be a wide range of opinions, some on one side, some on the other. And my only intent is to see that dialogue occurs and that what is produced is supported by the vast majority of the actuaries of the Academy, and is not just from a group of 15 actuaries who I'm sure in good faith did what they thought was appropriate. But I think there are many other points of view here that must be brought to the table before anything of this magnitude really comes to have any recognition whatsoever. I think all actuaries can support the movement to a gross-premium-type valuation or more gross-premium-type valuation. How it is actually implemented and what the assumptions that underlie it are the issues at this point.

MR. LAWRENCE SILKES: You mentioned that the use of blood testing has reduced traumatic deaths. Is there a quantification of that?

MR. COLLIGAN: As far as several very large company studies go, yes. As far as trauma death reductions go, I've seen some companies go from pricing mortality of 102-103% prior to introduction to some of these things down to 90%.

MR. SILKES: Besides that, is there a long-term effect on mortality that the preferred underwriter would have?

MR. COLLIGAN: That's where we're going to get into the lipid studies on the blood profile. Short term is external or trauma death. Long term are lipid studies that you're getting on the blood that you're not getting on individuals for whom you don't do blood screening.

MR. SILKES: What was the great improvement of mortality back in the 1970s? Was it the use of hypertension drugs?

MR. COLLIGAN: I think that was very true, yes. From stroke and coronary artery disease.

MR. SILKES: I don't want to put words in your mouth, but do you believe there'll be a long-term effect with the blood testing then?

MR. COLLIGAN: External cause, yes. That's going to be the most dramatic. What you're going to be doing is picking up people with lipid problems earlier. Now doctors are treating them, but there are going to be some people left untreated. I also think in the 1970s the reduction in mortality from coronary artery disease was due to the

initiation of coronary bypass surgery. That reduced it very much. But it's primarily the blood pressure medication.

FROM THE FLOOR: You also mentioned tumor screening. Is that going to have a dramatic effect?

MR. COLLIGAN: It's going to have a dramatic effect in a lot of ways. I think the regulators are going to get into it and make our lives miserable if we try and use it. I think it is probably going to, if we use it correctly, select out a good number of people that are uninsurable that we would otherwise put on the books, yes.

MR. JOSEPH F. KOLODNEY*: Just from a practical business point of view, don't you think that the industry is perhaps getting a little carried away with trying to continue discriminating on pricing for different classes? And doesn't it reduce the margins? It makes an assumption that you're actually going to get the underwriting that you're pricing for. And second, doesn't it tend to force some antiselection to make sure that the applicants get into that class? I come from an extensive reinsurance background, and (I'm sure you've experienced it), the eternal conflict is between the theoretical purity of the pricing of the product vis-a-vis the reality of what the underwriter has to do to demonstrate flexibility and respond to field force needs.

MR. COLLIGAN: I agree completely. And as I said, we're trying to fractionalize the risk into too many different pieces. We've got another thing coming to the floor with genetic testing. Now if we could get blood, and we can use genetic testing and we've got a cancer screening device, we're going to create a class of individuals that we can't charge anything for. And that's true. What we've done in creating so many tiers or preferred classifications is put the pricing pressure on the underwriter. The field knows that the underwriter is the one who's got to fit this individual into any one of 10 or 12 different underwriting classes. That puts the pricing pressure on the underwriter. If it were up to me, I'd like to see smoker/nonsmoker, and then let underwriters rate individuals that might be prone to trauma death (for example, that have four moving violations in the last three or four years or those we do find out drink a little bit too much). Let's rate them as we would the traditional underwriting valuations that we've always used, and not let underwriters determine whether or not we sell something because the actuary has said, "To get this low price down you've got to be Superman." I agree.

MR. COLLIGAN: It's fine with me if the reinsurers get a share of it.

MR. DAVID A. JEGGLE: I'd like to second Bill Bolton's comments. I've also been on the ACLI task force. I agree with Mr. de Palo; it would be helpful to get comments from more people throughout the industry on a basic reserving issue. But I would like to comment that a task force that includes representatives of the Guardian, the Prudential, the Aetna and Northwestern Mutual from the beginning is more balanced than what Mr. de Palo suggested in his comments.

* Mr. Kolodney, not a member of the sponsoring organizations, is Senior Vice President of Thomas A. Greene & Co. in New York, New York.

The real problem that is being addressed by the task force is not so much the reserving method, but the level of mortality. And I think Mr. Colligan's comments helped to point that out. The 80 CSO table is based on experience of the early 1970s and, as our task force is seeing, was loaded pretty heavily, especially in the nonsmoker area. And that's fine. What we're seeing now though is everyone who buys term insurance, at least from my company, is having a blood test and a urine test. We do not try to differentiate between different types of nonsmokers. If there's any tobacco usage indicated at all, they are not in the preferred or the nontobacco user category. All the other things that we get from these tests are very valuable to us. They're demonstrating that mortality can indeed be a lot better than is demonstrated by the 80 CSO table. We think it's appropriate to reflect that in the rates, and we think that's to the good of the buying public.

MR. DE PALO: Just so you know, there was no comment as to reflecting it in the rates. The issue is conservatism in the reserves, that the reserves will prove adequate, not for the average number of companies, but for the majority of companies. There's a basic underlying theory here that reserves, traditionally for statutory purposes, are not meant to be of a GAAP nature, but to be of a conservative nature and most companies will be holding reserves larger than they need to cover the fact that states cannot handle custom designing the reserves. Now underlying this is the question of the valuation actuary and can we rely on the actuaries of different companies to hold lower reserves in their companies based on known facts. This is a very broad issue that has been in this industry for a long time. And my contention is it's inappropriate to single out a single product and do something for it. The question is, Are the reserves currently held by these companies appropriate? If the question has to be answered, it has to be brought to the forefront of all actuaries. And my main desire at this time is to get a wide cross section of hundreds of actuaries, instead of 10 or 15 actuaries, to react to it. I think most people have not been reacting to it because the package presented by the committee is very extensive. It's a voluminous piece of work. There's pieces of it that I think have been done very well, and there's pieces of it which I also think have been done very badly. And most people I've talked to see the pile of paper, say it doesn't affect them directly, and haven't been looking at it. My intent is to get people to look at it. There's a consensus. The Society, the Academy, and everyone else will be responding to the consensus. What's needed at this point is involvement.

MR. JEGGLE: The proposed Guideline XXX reserves are considerably greater than what most companies have been holding for those types of products. So there is a substantial increase in reserves anticipated.

MR. DE PALO: There's one little word in that paper, as an example, with the use of select-and-ultimate mortality. And the word is the company "may" elect to use select-and-ultimate mortality. Do you realize that a company who chooses not to use the word "may" and will use the ultimate table will hold reserves substantially less than what that paper presents as the reserves?

MR. JEGGLE: It's true for some reserves but not others. And I think it was the plan of the task force that this would apply to all blocks of business or could be applied by a company to all blocks of business.

MR. DE PALO: I suggest that maybe the wording "may use select and ultimate" be changed to "all companies must use select and ultimate reserve." It would go a long way to strengthening that paper.

MR. GEE: Bill, did you want to add comment to it?

MR. SCHNAER: To me, the whole focus of statutory reserving, as Armand pointed out, is that actuaries cannot be trusted to set appropriate reserves. And the older I get, the more libertarian I become. But I think that regulation that prescribes exactly what needs to be done can never be complete, can never be totally descriptive, and invites, in fact asks for, people to find ways to get around it. A regulation that says your judgment is not to be trusted means "Fine, I will do exactly what the laws say, but no more." I think that's the case with term insurance reserves. I think it's the case with interest-sensitive product reserves. I think it's the case with statutory reserves in general: that the overregulation is inviting future insolvencies. That's my opinion.