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THE IMAGE CRISIS AND THE ACTUARY: UNDERSTANDING PUBLIC MISUNDERSTANDING

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Panelists: RONALD I. BECKER
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- What is the current public image of the life insurance industry?
  - Do life insurers meet public expectations?
  - Can life insurers meet public expectations?
- The public's view from the outside: the actuary's view from the inside
  - Why are these viewpoints different?
  - What can the actuary do to close the gap?
- How can actuaries improve the life insurance industry image?
  - The actuary as image maker
  - The actuary as educator
  - The actuary as communicator

MR. JOHN K. BOOTH: As we look back on the financial services industry and the business community in general during the last decade, we realize that they were dominated by an emphasis on image. Products were competing against one another on the basis of illustrated yields. Success was measured by leveraging to inflate financial statements. Wealth could apparently be created by financial transfers. The image of success brought more success. Eventually, people recognized they were not getting full value from the financial services industry and the image tumbled.

Today public attention has turned from image and yield to security and value. Insurance regulators and the industry talk of asset valuation reserves and valuation actuaries. Indeed, most of the public still expects the insurance industry to have the value to provide for everyone's financial security needs. People ask, "If life insurance companies by and large are really as solid and secure as they say they are, why can they not make insurance available at affordable prices to the sick and the dying, those who need insurance most?"

To tell us how the public perceives us and what actuaries can do about it, we have invited Dr. Brian Perlman to be our first speaker. Dr. Perlman is director of strategic research for the American Council of Life Insurance, where he is responsible for the annual Monitoring the Attitudes of the Public (MAP) Report, various insurance industry public relations campaigns, and analysis of such life insurance issues as risk classification and solvency. Prior to joining the ACLI, he held positions at the Arbitron Ratings Company, at Booz, Allen and Hamilton, and was a former vice president of the Mid-Atlantic Market Research Association.

DR. BRIAN J. PERLMAN: When John Booth approached me last month to give this talk, I had mixed emotions. While I was honored by his request to address this

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distinguished audience, I wasn't sure how to answer the question, what can actuaries do to improve industry image?

This issue reminded me of a philosophy professor who taught at my college years ago. For his final exam, he passed out a blank piece of paper with the word *Why?* written on it. If you answered "Why not?" you received an A. If you said "Because," you got a B. If you said, "Why are you asking this question?" you got a C. If you gave a page-long response, such as "'Why?' is a question that has been plaguing the human race for centuries. Poets, scholars, statesmen, etc. . . . ," you failed the course. I suppose if you exceeded a page you were kicked out of the philosophy program. Maybe that's the price you paid for a liberal arts education in the Vietnam War era.

If in that class I had had to answer the question of what could be done to improve the insurance industry's image, I would have received an F hands down. You see, there is no simple answer to that question.

The public image of the insurance industry is a very complicated matter. It goes beyond the performance of the industry, and it goes beyond the media image conveyed, although both of these are important factors. The image of our industry is also affected by what people know about the industry and what they want to know about it.

And perhaps as important a factor as any, although often ignored, is the whole role of insurance in our social fabric. This factor was discussed in a paper by Orin Kramer, commissioned by the Insurance Information Institute. We all know that insurance provides financial protection and in doing so promotes order in society. However, also included in the social fabric is what society expects of the insurance industry. Society expects that it will cover everybody, that it will do it at a very reasonable cost, and that it will stay solvent in the process. The image of our industry is affected not just by how well we perform, but by our performance relative to those expectations.

I would like to give you some understanding of public perception of our industry from data and first-hand experience. Let me begin by giving an overview of where the industry image stands overall. I will focus mostly on life insurance, since that is what most of our data address. Then I will briefly address public perception on two specific topics -- risk classification and solvency.

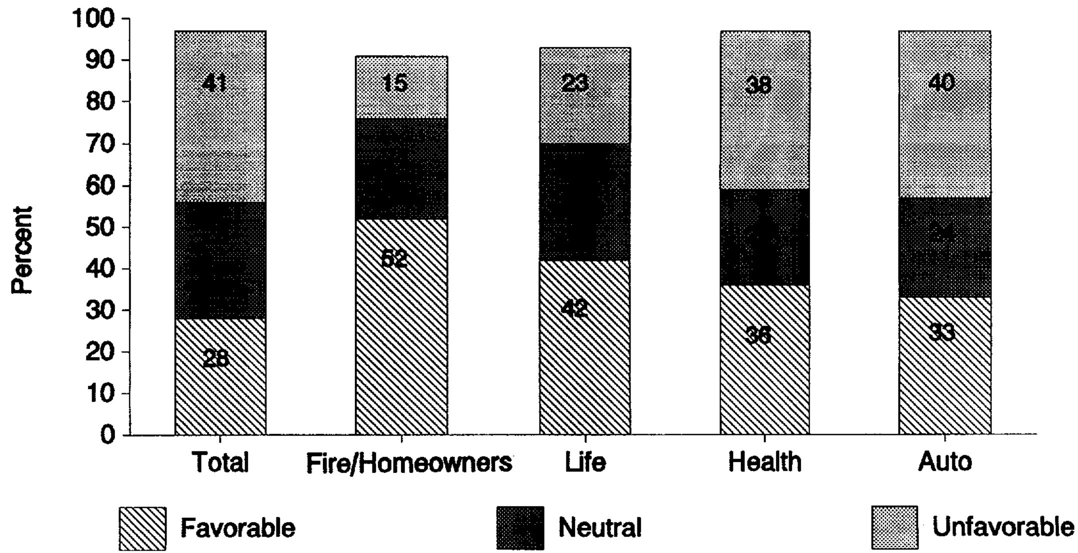
OVERALL IMAGE

The insurance industry in general does not have a very positive image, according to the 1991 report of MAP, our annual nationwide, door-to-door survey of 1,500 people. Only 28% of the general public has a very or mostly favorable view of insurance. If you compare this rating to that found for other industries, the news is even more depressing. Close to two thirds of the public have a favorable view of the communications and computer industries, and 41% have a favorable view of banks. Insurance falls more in the neighborhood of the nuclear power and chemical industries (28%) -- a neighborhood you don't exactly want to be in.

However, this negative view of the broad industry sector doesn't make a lot of sense when you look at reactions to the specific lines (Chart 1). The public has a more

CHART 1

Attitudes Toward Insurance Industry



favorable view of each of the lines than it does of insurance in general. Forty-two percent have a favorable view of life insurance, which is twice as many as those having an unfavorable view. Fifty-two percent have a favorable view of fire and homeowners insurance. Health and auto insurance fare worse than life or homeowners, but are still viewed more positively than insurance in general.

Somehow or other the concept of insurance has a negative connotation in our society, one which the public perhaps can't quite identify. Further examination of the life insurance product shows two other quirks.

First, on almost all measures there is a great deal of ambivalence about the industry. Chart 2 shows a pattern found for many MAP measures -- a very high level of "no opinions." On various personality traits descriptive of our industry, such as responsiveness, trustworthiness, and caring, as much as half of the public has no opinion. On historical trend items, the percentage with no opinion has grown tremendously in the last 20 years. That is an important factor to consider when you are talking about educating the public.

Second, there is a gap between how people view their own life insurance company and how they view the industry in general (Chart 3). If you look at the issue of price fairness, you can see my point. While only 28% of those without individually purchased life insurance policies and 43% of those with such policies think that life insurance companies are fair in the prices they charge, 74% feel that their own company charges fair prices.

This gap occurs with a variety of items relating to both agents and companies. There are many reasons for it. For example, people like their own things better than those owned by others. I like my congressman -- but I don't like congressmen in general.

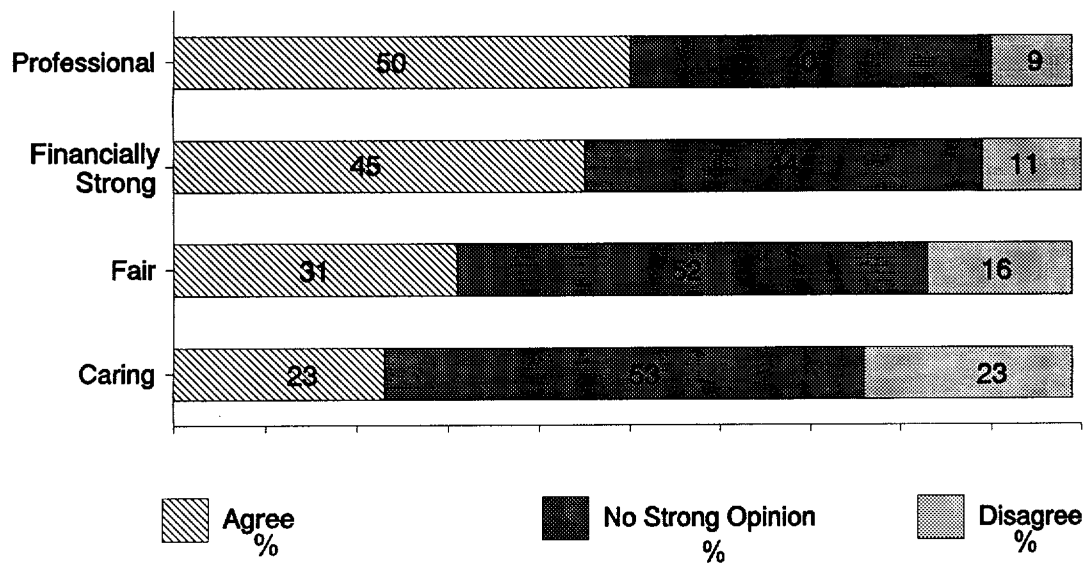
Other reasons for the gap may be a growing social trend toward disliking organizations and some rub-off of negative feelings from the lines that are not viewed as favorably as life insurance. Finally, some of the disparity may be caused by the way life insurance is sold. Many satisfied customers, with agents they like, may receive solicitations from a number of other agents during the year whom they don't like as much. Their views of the industry can be shaped by these experiences as much as by their satisfaction with the insurance they own.

Contrary to the slogan, "Familiarity breeds contempt," most psychological studies show that familiarity increases liking. And most of the general public is not very familiar with the life insurance industry. Our standard research joke is that if you want a question about the life insurance industry that a majority of the public can answer, ask, "The Prudential is headquartered in New Jersey; do you know where New Jersey is?" This lack of familiarity results in a cool reception for the life insurance industry.

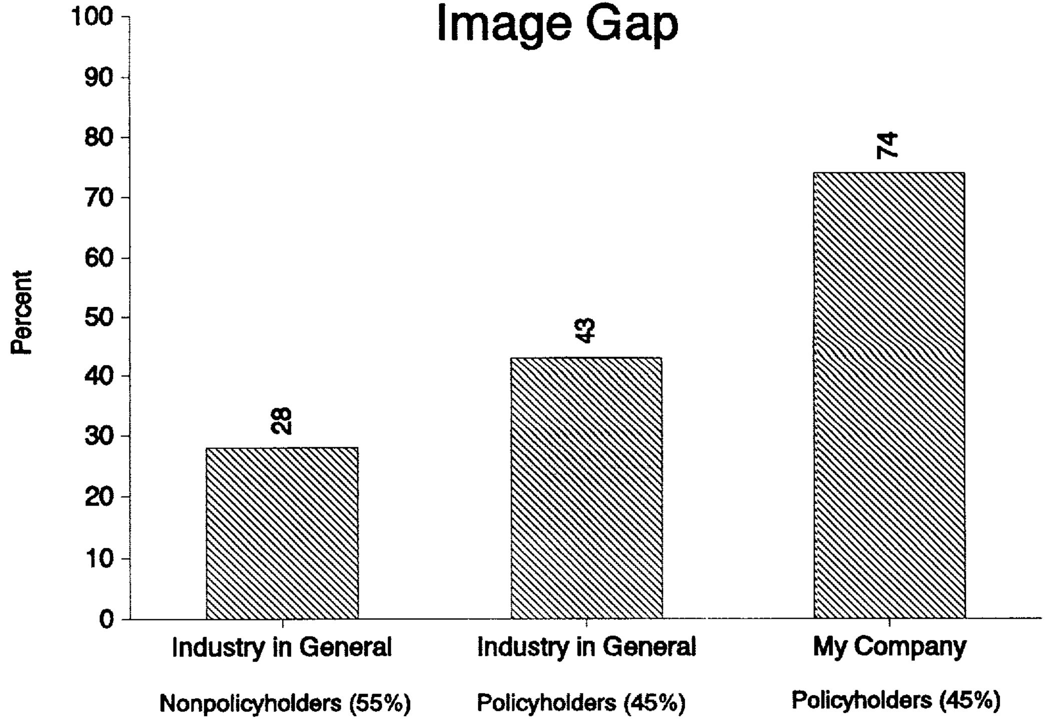
And don't think that this situation will get better. Although numbers have stabilized lately, fewer people now have contact with the life insurance industry, and thus fewer are likely to feel familiar with it (Chart 4). Twenty-five years ago almost 45% of the public reported having a personal life insurance agent. As of this year, only 28% claim to have one. Four years ago 56% reported having an individually purchased

CHART 2

Personality of the Life Insurance Industry



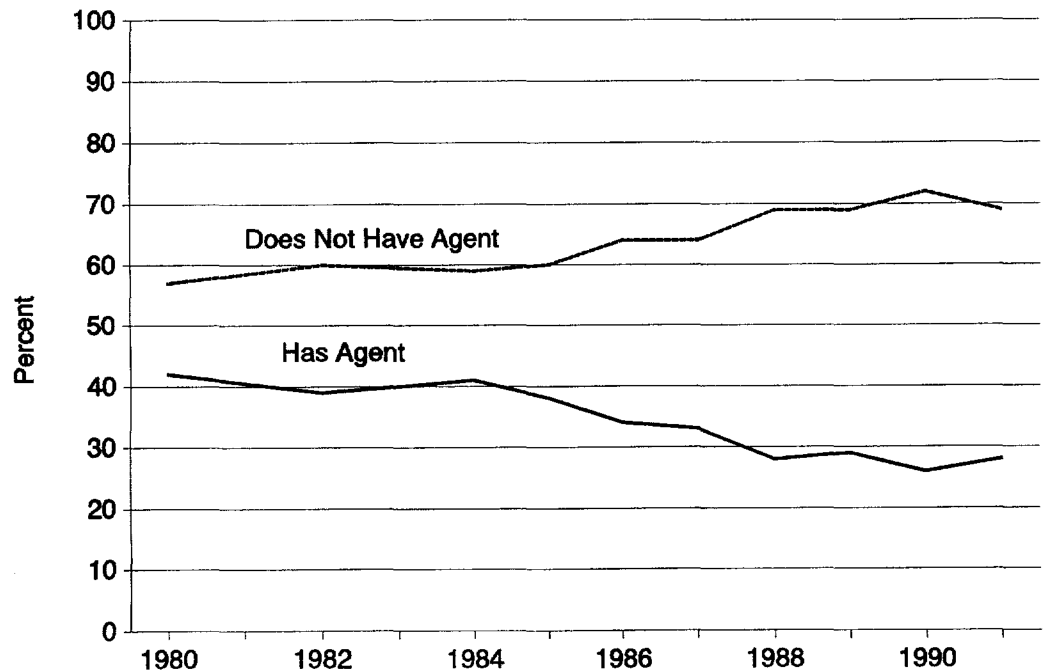
Fair in Setting Rates and Prices
Image Gap



OPEN FORUM
CHART 3

CHART 4

Existence of Personal Agent



policy. Now only 45% report having one (Chart 5). Let's hope that this is not a downward spiral -- fewer people own, image declines; image declines, fewer people own.

After studying the results of numerous focus-group sessions and in-depth interviews, I can tell you a few other things as well. Coupled with the lack of familiarity of life insurance is a lack of understanding of industry concepts. Although the public can benefit from education, many do not want to spend the time to be educated. Analogously, when a mechanic fixes a car, most customers do not want the details of what the mechanic did.

We also need to recognize that the public is not on our side. They do not feel pity when insurance companies are treated unfairly. Even if they understand our need to make a profit, as with any other business, whether or not we do makes little difference to them. What they do care about is how well life insurers serve policyholders -- how strong the industry is, the value of its products, and its claims-paying reliability.

Coupled with these tendencies are some issues raised by the other lines. How people feel about health and auto rates and their claims experiences with these lines influence their views toward all lines. Perhaps most importantly, many feel that health insurance and, to some extent, auto insurance are entitlements that should be readily accessible to everyone. This issue colors views towards all lines of the business.

Finally, as I'll discuss later, the financial strength of the insurance industry is an evolving issue in the image arena.

Let me stop now and show how some of these broad conclusions apply to two specific areas -- risk classification and financial strength.

RISK CLASSIFICATION

In the area of risk classification, we have historically asked several questions in the MAP survey and have heard comments on the issue in a variety of focus groups.

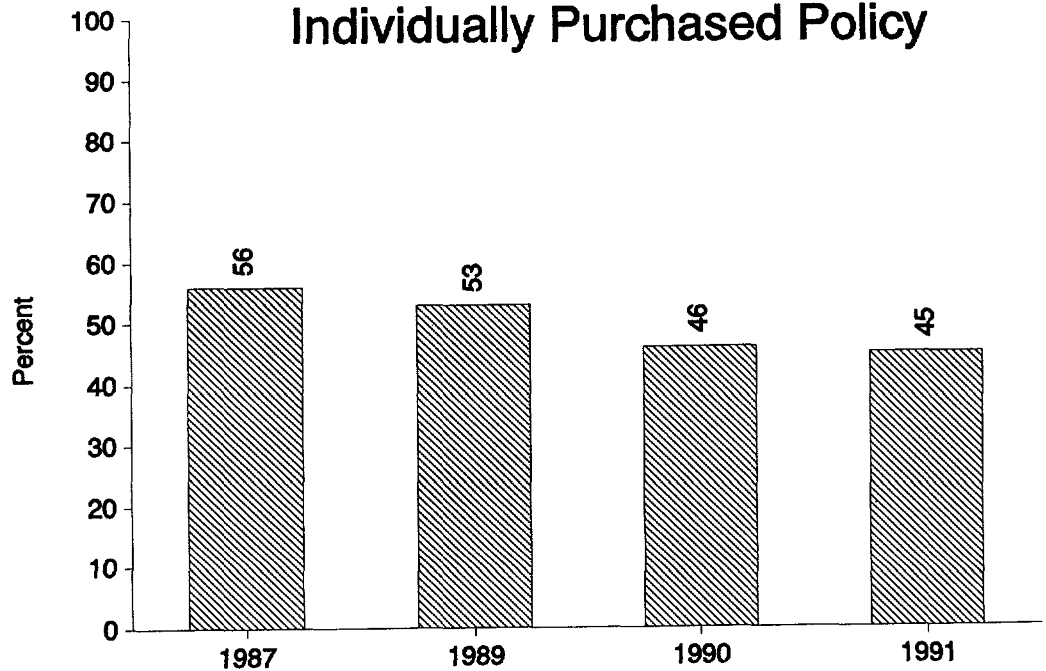
Let me start with some summary statistics from MAP on the general evaluation of the fairness of risk classification. While views towards the concept have fluctuated, in the last two years more have found it unfair than fair. Overall, 51% now find it unfair that persons with a higher risk of dying pay more for life insurance, compared with 40% who feel it is fair. As might be expected, given the entitlement issue, on a similar question for health insurance, 57% find the concept unfair, compared to only 33% who find it fair. Although it is not overwhelming, there is currently a general lack of support for the concept (Table 1).

TABLE 1
Fairness of Risk Classification

	Fair (%)	Unfair (%)	Don't Know (%)
Life Insurance	40	51	9
Health Insurance	33	57	10

CHART 5

Ownership of Individually Purchased Policy



However, support for the fairness of risk classification varies by situation. As you can see, when the applicant has control over the risk factor in question, there is more support for an insurance company's treating that person differentially, and vice versa. Two thirds of the public support charging smokers more than nonsmokers for life insurance. Only 31% feel it is fair to turn down an applicant with life-threatening cancer. Let's not touch the last category – genetic testing (Table 2).

TABLE 2
Fairness of Risk Factors

	Life Insurance Fair (%)	Health Insurance Fair (%)
Smoking	67	61
Hazardous Occupation	46	35
AIDS	40	24
Heart Attack	33	17
Life-threatening Cancer	31	16
Genetic Test/Cancer	14	9

Furthermore, look at equivalent data for health insurance. In every category, there is less support for the use of risk classification for health insurance than for life insurance – in some cases, such as cancer or heart attack, just about half as much support. Remember what I said about lack of sympathy for the industry position. The public, by wide margins, believes that we should write insurance on persons with life- threatening or terminal diseases.

One final blow. From a different perspective, the lack of support for the risk classification concept becomes even more apparent. Respondents were asked if they felt that selection guidelines make insurance unaffordable. For life, health, and auto the public agreed by margins ranging from 6-1 to 10-1 (Table 3).

TABLE 3
Selection Guidelines Make Insurance Unaffordable

	Agree (%)	Disagree (%)
Life Insurance	54	9
Auto Insurance	64	8
Health Insurance	65	6

From a variety of image-related, focus group work we have done, we have found anecdotal consistency with these findings. The concept of risk classification does not garner strong support. Again, there is far less sympathy for the use of risk classification in health insurance and with factors over which people have no control. If insurers deny health insurance to anyone, the public sees the industry as denying life-saving care, or at least subjecting the patient to far inferior care.

While some understand the business rationale for the use of risk classification, few support industry arguments that risk classification is a necessity for companies. The public is far more sympathetic to arguments about how risk classification is fair to policyholders and makes insurance rates more reasonable for them. Again, this sympathy is primarily for life insurers, not health insurers.

In image focus groups last June, we also tried to see if the public respected life insurers' ability to effectively price mortality risk – a specialty few others can do as well. In general, while they believed that the industry was quite proficient – a compliment to many of you here, it made them even more suspicious that the insurance industry uses this skill to hide profits from anyone else's scrutiny.

In general, the practice of risk classification is viewed primarily as a way of enhancing profits, by denying insurance to anyone with the slightest risk of dying or getting sick.

Clearly, this research shows how different the views of the public are from those of the industry. The public does not see risk classification as equitable, the way we do. Nor does it recognize or believe that the industry uses risk classification in order to avoid antiselection, the way we do. People believe the purpose is to make profits. Many do not believe that we want to write as many policies as possible; most believe that we want to deny as many as possible (Table 4).

TABLE 4
Risk Classification

Industry View	Public View
Equitable	Unfair
Avoid Adverse Selection	Squeeze Profits
Write Policies	Deny Policies

I'm sure Mr. Becker will shed more light on the logic and reason behind the industry's viewpoint. But how do we get a society that expects too much, doesn't want to understand, and has no sympathy, to listen to this logic? I don't have the answer to that. But raising the issue should be a good first step.

SOLVENCY

Now let me turn to the issue of solvency. I believe that in this area the public is not as knowledgeable as we might suspect, and thus is slow to react to news in the media. But let me warn you that this lack of attention to the story may not last forever.

In addition to devoting an extensive portion of its 1991 MAP survey to the solvency area, the ACLI has been tracking public attitudes in that area bimonthly since April 1990 and has also conducted 41 focus groups, either directly on the topic or tangentially related to it. We've heard extensively what the public has had to say.

Let me start with the tracking study. This study, which now regularly questions 4,000 respondents, asks people to report how acutely aware they have been of recent media events and to rate the financial strengths of various financial services industries, including life insurance companies, banks, savings and loans (S&Ls), property and casualty insurance companies, and brokerage houses.

This study shows that awareness of such problems has been increasing for the life insurance industry (Chart 6). Since last year, the percentage hearing little or nothing about life insurer financial problems has dropped substantially: from over 70% in April 1990 to 56% in August 1991. Although not shown, the biggest decline has actually been among those saying they have heard "nothing": from 42% to 25%. This is where we see that something had been happening. Also, look how much better we fare than banks or S&Ls. For example, only 21% have heard little or nothing about solvency problems of S&Ls.

Once again, these data illustrate that public awareness is far behind where we think it is. However, we may be passing a critical juncture shortly. The way trends have been going, in several months or less, the persons hearing little or nothing may drop below the 50% level, and a majority may report hearing at least "a fair amount."

We can see similar trends occurring with evaluations of financial strength (Chart 7). Since April 1990 there has been a slow erosion of consumer confidence. At one time 39-40% rated our industry as "very secure" financially. Now only 25% do. The biggest decline has occurred in the latest survey -- a five-point drop. We are not sure yet if this represents an acceleration of the trend or not. Again, the encouraging news is that we continue to fare a little better than banks in our ratings and much better than S&Ls.

On the other end of the scale (Chart 8), only 17% rate the life insurance industry as not too or not at all secure, a figure that has also risen this past month. The scary news comes when you look at both ends of the scale simultaneously. In April 1990 there was a gap in those who saw us as strong (39%) versus those who did not (9%). Now the gap stands at 25% versus 17%. In other words, the gap has dropped from 30 points to eight points.

Let me now turn to some of the 1991 MAP data. As you can see in Chart 9, in some areas there is strong evidence of a decline in consumer confidence in the past year. In 1989 and 1990, close to two thirds of the general public would use the description "financially strong" to characterize our industry. Only 45% now do so. I do not remember a drop of this magnitude ever occurring before in a MAP study. The good news is that most of this decrease has been picked up by an increase in those with no opinion, rather than by an increase in those who disagree.

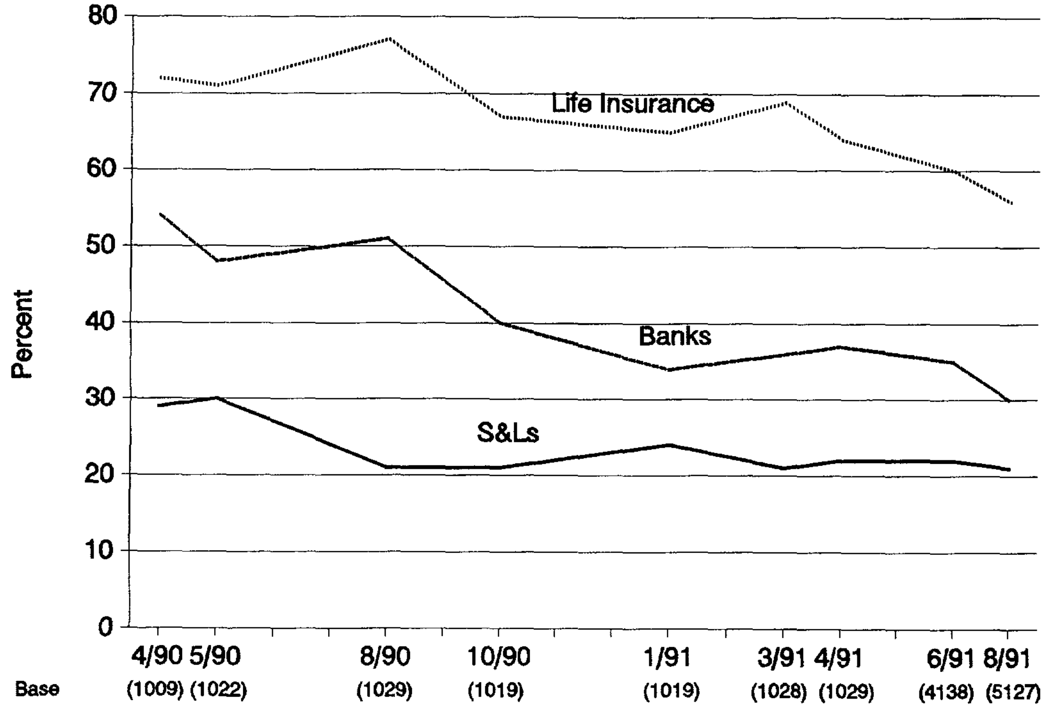
There is some moderating news here. If we look at confidence in claims paying, we see in Chart 10 that over the years, public confidence in life insurance companies paying claims has dropped tremendously, to 29% in 1991. However, confidence in one's own company is still at 62%.

Although a significant decline since last year, this figure is not that far outside the range of what MAP has found in the past. Here is a case where the image gap discussed earlier benefits the industry. People may not generalize stories about the industry to their own company and thus may not take actions as detrimental to our industry as one might fear.

Finally, MAP continues to show how little people know about our industry. For example, only about one third know how insurance is regulated. Only 26% of the

CHART 6

Awareness of Problems Affecting Financial Condition



% Who Have Read/Heard "A Little" or "Practically Nothing" About Problems

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CHART 7

Rating of Financial Strength and Stability

Percent of Total Respondents Saying "Very Secure"

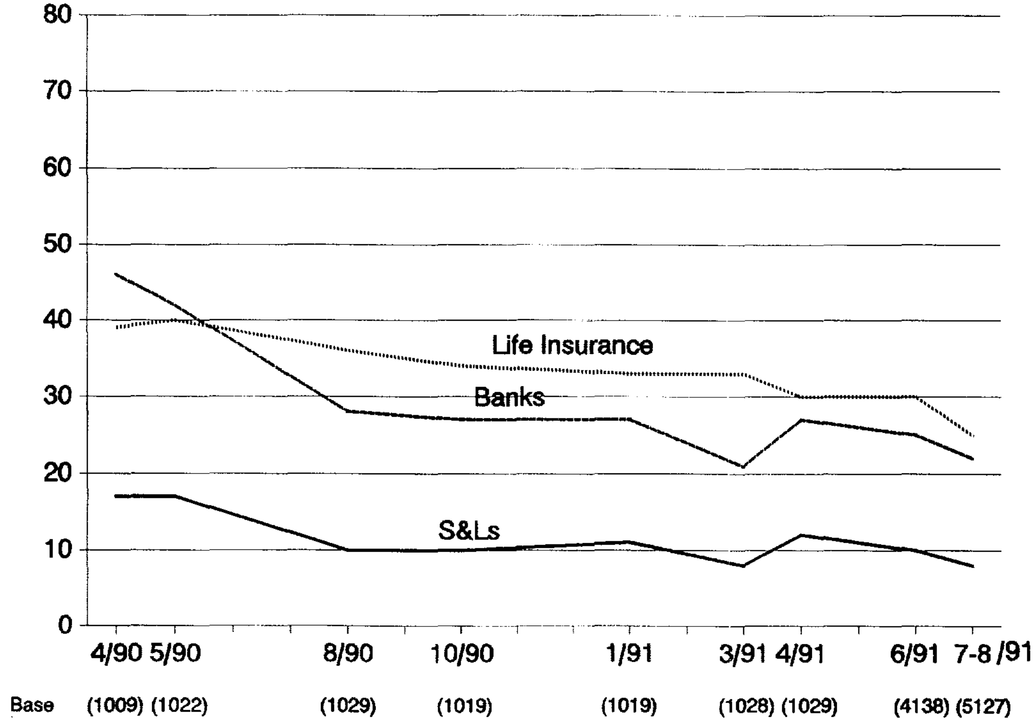

CHART 8

Rating of Financial Strength and Stability

Total Respondents

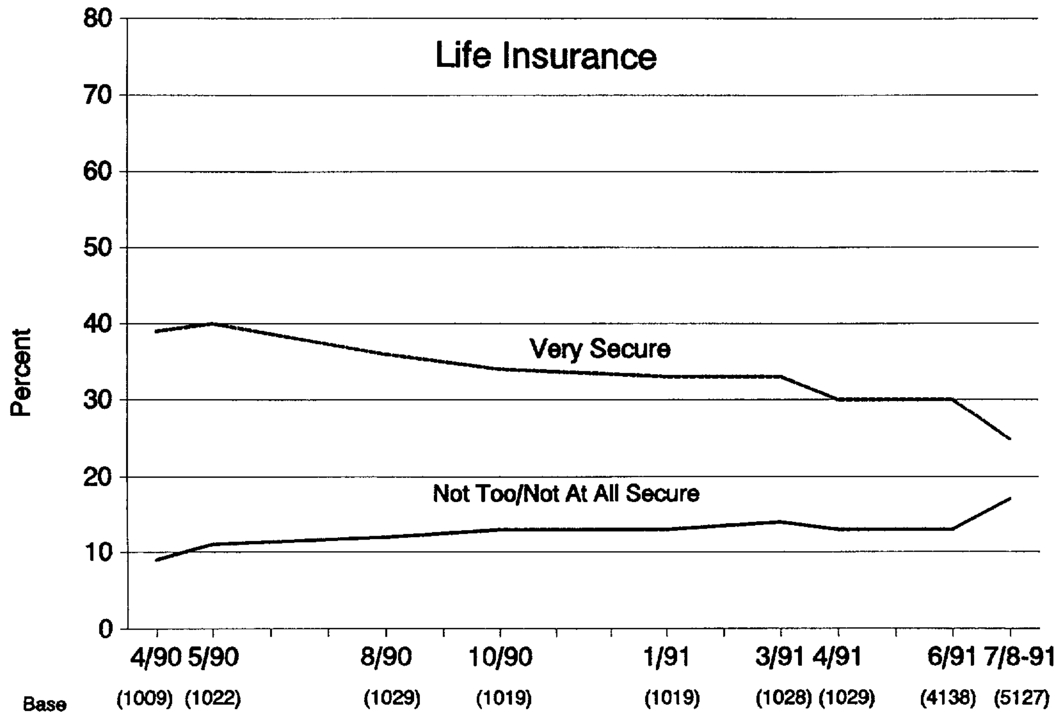

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CHART 9

Life Insurance Industry Is Financially Strong

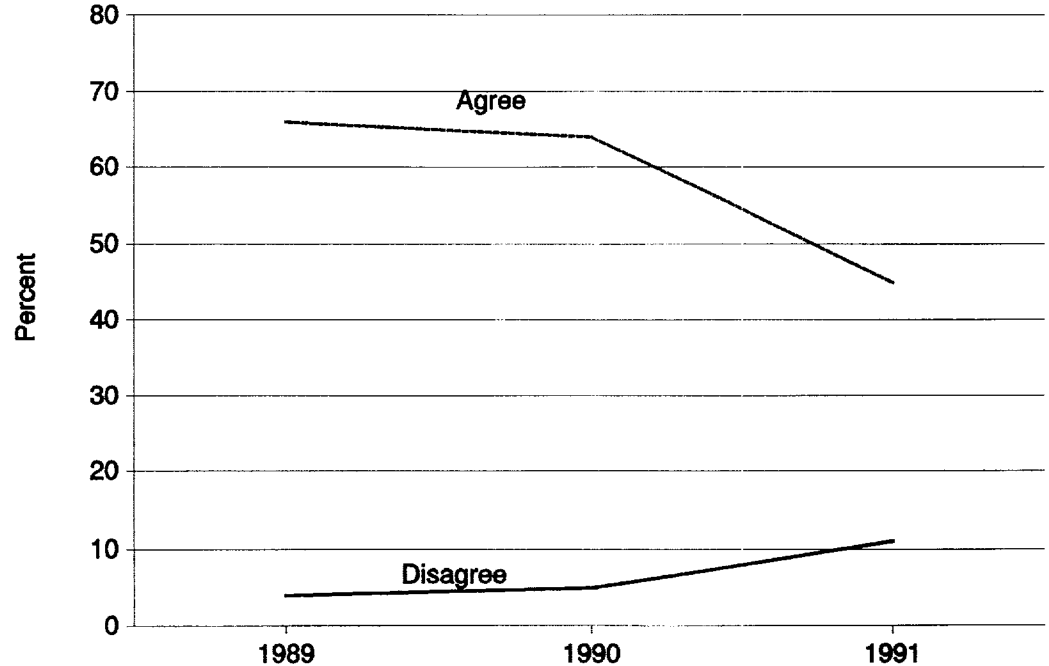
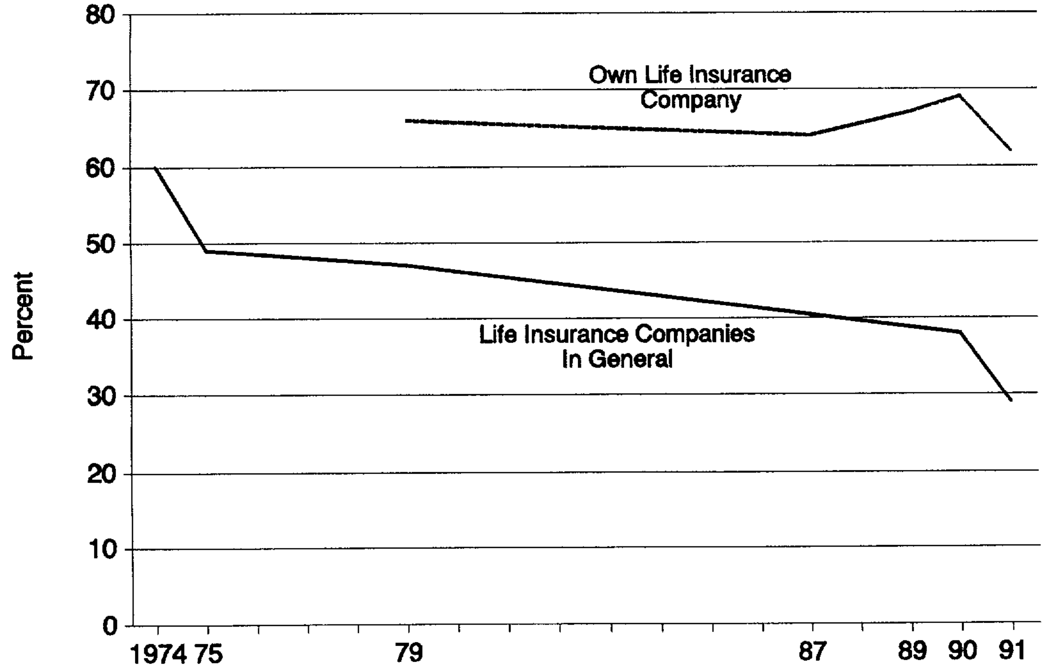


CHART 10

Confidence in Claims Paying
Very Confident



general public know that rating services exist. Only 9% of policyholders actually use ratings to evaluate companies (Tables 5 and 6).

Judging from these data, how much of consumer confidence and public perception is related to actuarial reality, and how much is a function of how the story is told?

TABLE 5
How Life Insurance is Regulated

	%
State	33
Federal	22
Not Regulated	14
Don't Know	31

TABLE 6
Awareness of Independent Rating Services

	%
Aware	26
Unaware	69

This is where the numerous focus groups we have conducted come into play. The focus-group experience confirms many of the generalizations I made earlier in my talk. In January 1991 we interviewed eight groups. At that time Executive Life was in trouble, and speculative stories were calling the life insurance industry the next S&L crisis.

Nonetheless, in January many of the general and upscale participants had heard nothing about any problems with the life insurance industry. They had heard about banks and S&Ls. People in Boston knew of friends who took their money out of the Bank of New England in boxes. Nonetheless, when we asked about the problems faced by the life insurance industry, we got a blank stare from many -- a welcome reaction for us.

At that time the public wanted nothing more than general, reassuring messages from the industry. They didn't want us to talk about "what ifs," since the event of a life insurance company failure was remote. They thought that even favorable comparisons to the S&L situation created a linkage that needn't be made.

Ironically, the perception that our industry is profit-hungry, which I covered in my discussion earlier, actually was beneficial. Based on experiences with high auto insurance premiums, participants were sure that the industry was reaping huge profits. Insolvency was the last thing on their minds.

However, this pristine environment began to change between January and June 1991. In June we held focus-group sessions again, with a variety of upscale respondents. Even among the least sophisticated, the change from January was readily apparent. Most had heard something about financial problems faced by our industry. No longer were respondents reassured by positive generalizations about our industry.

Rather, the June respondents were more interested in hearing about the layers of protection and safeguards provided with life insurance. In other words, now they cared about what would happen in the event of a failure. Descriptions of regulation and guaranty funds were well received.

Also, consistent with everything I've said, it was amazing how little respondents knew about the issues. Our messages about regulation and guaranty funds were well received, because they were news to many people.

What impact will solvency questions have on the image of the life insurance industry? It is hard to say. Some industry analysts say that financial strength is the best asset the life insurance business has, and if this pillar falls, its image will fall with it.

So far, however, while the pillar has been shaken, the rest of the building has not appeared to suffer any damage. As I've shown earlier, despite large declines in the perception of the insurance industry's strength, its image has not eroded very much in the past year.

Furthermore, we see only minimal evidence of people acting on solvency fears. A few large investors say they will diversify more, but most plan on sticking with their contracts. Keep in mind that if we study focus groups on banking, we might find some wealthy investors diversifying out of banks and into insurance products.

SUMMARY

What can we do to improve the image of our industry? The first step is to understand the public's viewpoint -- to identify what people really want to know. Then tell it to them.

For example, the public does not want to know why companies have to use risk classification, or how good they are at it. They are simply not going to take our side for those reasons. The public does, however, want to know how risk classification benefits and is fair to a majority of people. The public may find it informative that a large majority of life insurance policies are rated in the standard class. This information may serve to overcome myths about the industry that have a detrimental impact on its image. The public might also understand that young fathers and mothers could not protect their families, if they paid the same amount for life insurance as did 75-year-old nursing home patients. Our MAP survey shows that people have a very high opinion of the use of life insurance as death protection.

The area of financial strength presents a very different picture. Here the inertia involved in the trend of the industry's positive image, and the lack of attention to the story by the general public, have worked to its benefit. Also, the public wants to be on our side on this one. Banks and S&Ls are failing, and people don't want to stick their money into a mattress. However, our window of opportunity may be fleeting. If trends continue, we could be on the defensive shortly on the financial-strength issue.

In this area, the public has no interest in actuarial facts and figures. People don't understand them, nor are they motivated to learn more about the actual financial strength of a company. Rather, the public is looking for a very general explanation as to why their money is safe. They generally want to know that regulation and guaranty funds exist. They do not want very much detail on the mechanics.

People find it hard to believe that we really work with regulators to improve state regulation; that stretches their beliefs about us and corporate America in general. However, they are encouraged that we willingly abide by ever-toughening laws.

It is quite clear that the image of financial strength can benefit from communications with the public. We just need to do it carefully. We also need to recognize that, on this issue, everything can change in the next six months.

While financial strength may be related to ratings, asset-liability ratios, and debt-equity ratios, to the consumers there is more involved. They are also concerned about our willingness to pay claims, and the ease of collecting on a claim. In this last area in particular, data I've seen suggest that the life insurance industry does well. The fact that money can be received without probate, without lawyers, without IRS intervention, gives the life insurance product an advantage, irrespective of company strength.

Overall, imagine yourselves back in that college philosophy class. When the public asks "why," provide the simple, straightforward answer for which they are looking. If you don't like the question, don't get angry, get strategic. Understand what they have in mind and what they want to know. If you don't, you may fail the exam. If you do, it may be a first step toward improving the image of the industry.

MR. BOOTH: Our next panelist, Robert Fillingham, has recently begun his own actuarial consulting practice. For the past year he has worked as an insurance industry analyst with Moody's Investors Service. I have asked him to discuss the industry's public image regarding solvency, from the viewpoint of an actuary who has been directly involved in the rating process.

MR. ROBERT S. FILLINGHAM: I believe that one of the most useful things actuaries can do to help with the insurance industry's current image difficulties is to become increasingly active in the public discussion of the challenges it faces. As Daphne Bartlett suggests in a recent special message published in *The Actuary*, this is particularly true of the solvency issue.

Since the rating services have become so important in shaping opinion on this issue, an understanding of their approaches to life insurance credit analysis will be needed to be effective in discussing solvency issues. I believe most of the services have published material covering this, and I would encourage you to obtain and carefully study it. You may also find it instructive to read and compare the credit research reports that are published for a number of companies, to get a fuller sense of the differences and similarities in their approaches and thinking. Here are a couple of general observations to keep in mind with respect to the major bond rating services (Duff and Phelps, Moody's, and Standard & Poor's):

1. Claims-paying ratings are set using time-proven practices in rating bonds. However, the life insurance industry is still comparatively new for the services; arguably, their practices have not been tested long enough for their predictive value to be accepted without question.

2. The bond-rating paradigm used involves a very long-term perspective focusing on plausible worst-case scenarios.

For the insurance companies that are given fully developed ratings by the major bond-rating agencies, the opinions expressed currently run, on average, fairly high: somewhere, say, in the middle of the above-investment-grade ratings. These opinions have been moving downward over the past year and particularly over the past few months, largely in response to concerns over risky assets. Despite this, life insurance compares favorably with other financial-service-industry sectors. A recent article in *The Wall Street Journal* notes that no U.S. investment bank is rated higher than A+ by Standard & Poor's or A1 by Moody's. According to this article, there is only one triple-A-rated U.S. money-center bank, and the average U.S. money-center bank rating by Moody's has fallen from close to Aaa in 1978 to close to Baa1 in 1990.

While insurance claims-paying ratings haven't been established by these agencies long enough to develop a statistically significant measure of their predictive value, if we assume they are equally as predictive as bond ratings, we can use the published bond default rate studies to get a sense of the risk associated with various insurance claims-paying ratings. Moody's latest study of its corporate bond default rate experience during the past 20 years shows the following cumulative 10-year average default rates (Table 7):

TABLE 7
Moody's Corporate Bond Default Rates 1970-90

Original Rating	Cumulative 10-year Average Defaults per 1000 Issues
Aaa	4
Aa	7
A	10
Baa	38
Ba	113
B	242

Notice how slight the differences in default rates are among the top three classes (4 per thousand at Aaa, 7 per thousand at Aa, and 10 per thousand at A). In the bond markets, these differences in risk levels are dealt with through diversification and the credit-risk pricing differentials. In the insurance marketplace, diversification probably isn't practicable, except at the wholesale level, and clear price differentials recognizing these risk differences remain, so far as I know, to be developed.

Over the past few years, the published opinions of the rating services have assumed an importance far beyond what was probably expected when they first began assigning them. Most of the bond-rating-service ratings are for various debt or preferred stock issues and are of interest chiefly to relatively sophisticated investors who would regard them as opinions to be supplemented by additional research, taking into consideration other security features. The employment of a sophisticated tool by those unfamiliar with the details of how it has been constructed, its limitations, how it is intended to be employed and interpreted, can lead to misunderstandings and misinterpretations. An example is failure to recognize the widely varying risk significance of a one-notch change at various points across the rating scale, as suggested by the historic default rates mentioned earlier.

On the question of whether public expectations are and can be met, I would note that the key expectation of receiving contractual guarantees has, with relatively few exceptions, been met. The gravest threat to meeting these expectations is a "run on the bank," which, in theory, could confront any company. Companies that are clearly well prepared to successfully meet such a threat, and/or those that are especially free of the risk of such a run and can convincingly communicate that fact, have a powerful competitive advantage. Claims-paying ratings address the contractual guarantee of timely payment to senior policyholder claimants, not other policy or service features or price. Note the word *timely* here. Rating agencies consider late payments as defaults, even if no actual losses are experienced by policyholders.

On the topic of contrasting and narrowing the gap between the actuary's inside view and the public's outside view, Dr. Perlman makes the point well that the public can't be expected to have an in-depth understanding and appreciation of the realities of a company's or an industry's weaknesses and strengths. It is that very limitation, of course, that gives rise to a demand for ratings. Especially highly leveraged efforts to close that gap are those aimed at working effectively with the rating services that do have the interest and resources -- indeed, the need -- to understand your inside viewpoint. To work optimally, this effort will need to be combined with improving the quality of the public's understanding and interpretation of ratings.

The program notes three possible roles for the actuary: imagemaker, communicator, and educator. We have spoken of the last two. What about imagemaking? While at first I was inclined to see no imagemaking role, if we think of the influence actuaries have on shaping the practices of the industry in pricing, valuation, financial reporting, regulation, etc. -- its infrastructure, if you like -- as a form of imagemaking, then in this sense we can certainly look at possible imagemaking contributions -- or, if you prefer, contributions other than as educators/communicators.

To do this, let's note some of the forces that led to where we are in terms of solvency issues. The life insurance business mix has shifted from 50% in life insurance to under 30% over the past decade, while accumulation products (individual and group annuities and guaranteed interest contracts) sold in a fiercely competitive marketplace (including other financial service industry sectors) have moved up to around 70%.

These dynamics have pressed life insurance companies to add credit risk and/or disintermediation risk to their risk portfolios without fully commensurate increases in risk capital. This has all been taking place in a regulatory setting that was designed for a very different world -- a world in which the life insurance industry was primarily engaged in the business of selling and administering long-term life insurance contracts;

a world in which conservative, statutory accounting practices combined with very low minimum capital requirements worked well.

There appears to be no reason to think this "annuitizing" of the industry will be reversed anytime soon. If so, pressures for continuing and/or adding inadequately capitalized risk will remain. In addition, the recent difficulties of a few large companies have focused attention on event risks like "bank runs" and preemptive takeovers.

This suggests that the ways in which actuaries will be addressing solvency image problems will also include such things as:

- Making product design changes to more appropriately recognize the value of guaranteed-withdrawal-value options,
- Seeking to improve life insurance industry regulation, to help improve its fit with today's realities and provide regulators with the resources they need to do a difficult and complex job, and
- Working on improving the credibility of the industry's financial reporting. If it is perceived as arcane -- the sole province of experts -- its credibility suffers.

MR. BOOTH: Our next panelist is Ronald Becker, second vice president, new business services, at The New England in Boston. As a member of the Risk Classification Committee of the American Academy of Actuaries, he will give you a brief look at a slide presentation developed by that committee to educate the public on the need for risk classification in the insurance business.

MR. RONALD I. BECKER: I can't help thinking that actuaries representing the insurance industry to the public can sometimes be our own worst enemies. A couple of simple illustrations:

1. You are with someone not connected with our industry, and you are asked where you work or what you do. A response I've heard a number of times is: "I work for Megabucks Mutual Insurance Company, but don't worry, I don't sell insurance; I'm an actuary." The negative view of insurance salespersons has just been strengthened by raising it and implying informed agreement.

2. Or, after stating that you are an actuary, you pause an extra beat while you decide whether the person's blank look reflects not knowing what an actuary is or just not caring. If you guess wrong, you risk insulting people's intelligence, or boring them, or both.

It is important to recognize that in both business and social relationships, you are viewed as a representative of the insurance industry and the actuarial profession. One of the greatest strengths actuaries have is our professional recognition. Although the majority of the public does not know what an actuary is, those who do have a very high regard for our intelligence and skill (despite the wealth of actuary jokes that exist). Our challenge is to make ourselves known to more of the public.

I want to use most of my allotted time to acquaint you with a program developed by the Risk Classification Committee of the Academy. My purpose is twofold: first, I hope you will avail yourselves of the program directly; second, I hope your thinking will be stimulated to develop other means of improving our image and educating our public.

The Risk Classification Committee of the Academy is often called to participate in the governing process at the federal and the state levels, both through the filing of briefs and through expert testimony at public hearings. The Committee's work is complicated by the lack of understanding of even the most basic insurance principles by much of our audiences. A number of years ago it was decided that the Committee could benefit greatly from the development and wide dissemination of a risk-selection educational program. A slide presentation titled "Risk Selection: The Science and the Fiction" was created, and a nationwide group of presenters has been formed. Some of you may have seen a preliminary version previewed at the 1990 regional meetings of the Society. Our goal is to get in front of as many audiences as we can, to give our message the widest possible hearing.

The presentation is designed to be simple, straightforward, logical, and even slightly entertaining. We believe that the image of the insurance industry can be enhanced by educating our public and that, since the presentation was developed and is given by actuaries, our profession's image will benefit as well. Ideally, the presentations will be made jointly by a life actuary and a casualty actuary, both prepared to deal with a wide variety of queries during an open question-and-answer session following the slide presentation.

I will now review selected portions of "Risk Selection: The Science and the Fiction." It sounds a little like we're here for a science fiction retrospective. Not so. But I would like to direct your attention to this issue (slide shown of a 1939 *Sci-Fi* magazine cover), of one of the early science fiction magazines, going back some 50 years. It contained a story entitled "Life Line," by Robert Heinlein.

Now, Mr. Heinlein was not an actuary, nor was he ever associated with the insurance industry. But he was a gifted writer. He tells a tale about a man who invents a machine (slide shown of a futuristic machine). It's an early computer, and for a fee it will compute a person's date of death. The inventor makes a fortune, and the life insurance industry collapses in short order.

It's a well-crafted story. But it's science fiction. In the real world, there is no way to predict life's contingent events with such certainty. Instead of Mr. Heinlein's futuristic machine, we rely on actuaries. Actuaries make use of a powerful tool know as risk classification, so that insurance companies can properly evaluate the risks they underwrite.

As actuaries, we believe that no topic in our domain is more misunderstood and more in need of explanation than risk classification. Much more than an equation or symbol that gets lost in the mathematical shuffle, risk classification is a basic, underlying principle of actuarial science. (Slide of math symbol jumble is shown.)

Let's start with a definition. Risk classification is the process of grouping risks with similar risk characteristics, so as to appropriately recognize differences in costs. This process is an integral part of the insurance business, and as such, if it is misunderstood or misapplied, it can lead to adverse consequences. (Slide of the *Life*

Insurance Fact Book is shown.) Risk classification, or, to be more accurate, inappropriate risk classification, has been a significant factor in insurance company insolvencies in the United States.

With apologies to Mr. Heinlein, let's delve into nonfiction and look at a real world example of how one insurance company collapsed. (Slide of Prudence Mutual annual statement is shown.)

Prudence Mutual Insurance Company (yes, that really was its name) was a moderate-sized casualty insurer located in Chicago. The company originally specialized in individual disability income policies.

In the early 1970s, new management took over the company and decided to use its casualty authority to write auto insurance. The new management believed that people who lived in Chicago's blue-collar neighborhoods were being unfairly discriminated against, because they were being charged auto insurance premiums that were too high. (Slide of traffic jam in Chicago is shown.)

So, on the basis of this belief, management ignored the actuarial evidence and wrote auto insurance for drivers in these Chicago neighborhoods, at rates that would have been right for a population with far fewer auto accidents. The result: you guessed it. Prudence Mutual went belly up. And everyone involved got hurt. (Slide of hurt worker is shown.)

All the company's lines of business were affected, including its disability income line. Many disabled individuals who had long depended on income payments from Prudence Mutual lost those benefits.

This is not just a story about mismanagement and its sad human consequences. It's also a story about the dangers of ignoring appropriate risk classification. Risk classification is a powerful, analytic tool that must be clearly understood by all involved in the management and the regulation of voluntary insurance programs. It is a concept, furthermore, about which there is a good deal of confusion in the media and in the public policy arena.

Much of the confusion related to risk classification revolves around a single word that is often treated as synonymous with risk classification: discrimination. In today's world, this word often has very negative connotations.

But, it's a word with several meanings -- some negative, some positive. There is both fair and unfair discrimination. To an actuary, unfair discrimination means inequity. It represents an unfair charge to one individual or group to subsidize another individual or group.

Systems of risk classification permit insurers to respond fairly to valid cost-and experience-related differences among persons or properties. To help guide actuaries in developing these systems, the actuarial profession, through the Actuarial Standards Board, (slide of Actuarial Standards Board logo is shown) has recently adopted a risk classification standard of practice.

This standard enumerates three basic requirements for an appropriate risk classification system. Risk classification must be fair. Risk classification must permit economic incentives to operate and thus encourage widespread availability of coverage in the marketplace. And risk classification must do its part to keep the insurer solvent.

To achieve these ends, a sound risk classification system should be based on four principles, which are also spelled out in the actuarial standards literature. First, risk classification should reflect cost and experience differences. Second, the system should be applied objectively and consistently. Third, the system should be practical, cost-effective, and responsive to change. This means there are limits on how much effort and money can be spent to classify a risk. And, risk classification systems are dynamic; for example, when polio was eliminated as a public health hazard, the system changed to reflect that development. Fourth, and perhaps most crucially, antiselection should be eliminated. Antiselection is an actuarial term that requires some further explanation. Applicants for insurance often know more about their own risk factors than the insurer can learn in the application and underwriting process.

However, a sound risk classification system should limit the ability of the applicant to take unfair financial advantage at the expense of the insurance company or other insureds. This unfair advantage, in essence, is what we mean by antiselection.

So far, I've talked about some of the concepts underlying appropriate risk classification. Let's move on to some specifics of how risk classification is actually used by actuaries.

Actuarial evidence is a term that frequently appears in state and federal legislation, but what does it really mean? What is the nature of actuarial evidence? There are, essentially, two types of objective evidence.

The best evidence is statistical analysis of information from actual insurance claims – how many claims were filed and for how much. Unfortunately, reliable claims data are frequently the last information available, especially when conditions are changing, like when there have been significant innovations in auto safety.

A second type of actuarial-evidence data may be drawn from engineering, clinical, or other types of studies. AIDS is a case in point. AIDS develops slowly and kills relatively quickly; but because it has emerged fairly recently, we don't have a large volume of insured data yet. We do, however, have substantial clinical evidence that indicates the likely substantial adverse effect of AIDS on future insurance claims.

Of course, there are occasions when it's necessary to rely on subjective evidence – by which we mean informed actuarial judgment and common sense. Even in the absence of insured data, common sense would dictate higher casualty insurance premiums for fireworks manufacturers than for dairy farmers.

You'll notice that in discussing actuarial evidence we haven't said anything yet about causation. Some have suggested that establishing causation should be a requirement for classifying risks. Let's consider whether or not knowledge of causation is necessary for sound risk classification.

Sometimes we know that one event causes another. (Slide of thumb and hammer is shown.) This man's aim with the hammer caused that problem with his thumb. That's causation.

However, the inability to establish cause and effect is sometimes improperly equated with a lack of evidence of the relationship. We might not know exactly how smoking leads to cancer, but the relationship is very well documented and is certainly very clear, because of the high degree of correlation between the two.

In recent years, classification factors like gender, age, marital status, and physical handicap have received a lot of attention -- from the news media, federal and state legislators, and insurance companies themselves. (Slide of news headlines is shown.)

In some cases, actuarial evidence, although clear, has been disregarded in an effort to improve perceived social inequities, as in the unisex controversy. In other situations, actuaries are being asked to resolve social issues on the basis of actuarial evidence that is fragmentary or inconclusive, at best. (Slide of perplexed actuary is shown.)

For example, some states have enacted statutes or regulations requiring that actuarial evidence be supplied before handicapped individuals can be charged different life insurance premiums. There is, however, a dearth of actuarial evidence to support many of these requirements, however worthy or noncontroversial they may be. (Slide of reading braille is shown.)

These mandated requirements can be viewed as manipulations of risk classification. In essence, the actuary is being put in the position of justifying a predetermined public policy without sufficient data.

If the social issues are complex, the risk classification issues are equally so. And mingling these two sets of issues makes for even greater complexity.

However, there is one distinction that is central to nearly every public policy debate that involves systems of sound risk classification. That distinction is whether equality is more important than equity. (Slide of equality and equity scale is shown).

In the context of insurance and risk classification, equality means charging the same price to all buyers, regardless of differences in the value or underlying cost of the benefits provided, while equity means charging each buyer a price that is commensurate with the value of the benefits to that buyer.

Providing equity within the system through appropriate risk classification maximizes the opportunity for insurance, by making lower and more equitable prices more readily available to lower risks.

Increased equality is frequently a goal of social policy and, appropriately, is a major concern of our legislators and regulators. As actuaries we do not oppose equality, in and of itself. However, the means by which it is increased can have unanticipated consequences and, in some cases, results are opposite to those intended. Because of our expertise, we believe that we have a responsibility to encourage those who make public policy to understand the impact of a proposal or a decision on the insurance system as a whole.

Because we all operate in a dynamic, changing, and endlessly challenging environment, insurers, actuaries, and regulators must work together to keep the three basic requirements of risk classification from being lost. (Slide of actuary and others is shown.) Accordingly, they're worth repeating once again.

Risk Classification must be fair. It must let economic incentives work and so encourage widespread availability of coverage. And, it must keep the insurer solvent.

We may not have Mr. Heinlein's futuristic machine available to us . . . (slide of futuristic machine is shown) . . . but we have, nonetheless, a powerful tool. ("Risk Classification" is shown on a slide.)

With risk classification, understood and applied as it should be, we have a means for helping insurance companies properly evaluate the risks they underwrite, helping ensure that policyholders are safe and secure. (Slide of a crowd is shown.)

That's my version of a coming-attractions preview for you. If you want to arrange for a complete viewing in front of an audience in your own locale, please contact me or any other member of the Academy's Risk Classification Committee. In particular, the Committee's chairperson is John J. Kollar, at the Insurance Services Office, in New York City; or you can call Gary Hendricks or Erich Parker at Academy headquarters in Washington, D.C.

MR. BOOTH: We have just reviewed what the public thinks of the life insurance industry. We have heard how the rating services develop opinions about life insurers, and we have seen a presentation that the Academy has put together explaining the need for risk classification. Brian, is the Academy's presentation going to get our message across?

DR. PERLMAN: I think we just need to be sure that we don't focus on how risk classification is necessary and how it's important from a statistical, mathematical, and business sense. That's not going to sell. I think it's important, when you go through those slides, to focus on how risk classification is fair and what advantages it gives the policyholder.

MR. FREDERIC W. CORWIN JR.: I work on guaranteed interest contracts, and my thoughts concern solvency more than risk classification. Has the ACLI done any research on group insurance and group pensions, where the ultimate beneficiary is the plan participant, but the buyer of the service is the plan sponsor? I have found anecdotally that many plan participants have no notion of the insurance company solvency issue, although plan sponsors clearly are much concerned about their fiduciary responsibility.

DR. PERLMAN: We're about to embark on some research in that area. I was in New Orleans last week with the Life Office Management Association's group pension investment managers, and I asked them for input as to how we could address their audiences. It's a tricky situation. For one thing, I would feel uncomfortable having in a focus group a plan sponsor who has purchased a $60 million contract. What I believe we're going to do is pull together some people who represent plan sponsors, some consultants, some people from pension-oriented trade associations, and some marketing people, and get their reaction to messages that we've been using with the general public. We may also get the reaction of some marketing people to messages we may use and then try to design the best communications we can for that audience.

I found it fascinating to talk to some of those group pension managers, because they confirmed a finding from a focus group we had held in which several people representing plan sponsors didn't know what a guarantee fund was. The group pension managers told us that the representatives of some of the smaller sponsor organizations have an average income of $35,000 a year and that in some cases the people making the selection, or at least introducing the product to the sponsor, have a very low level of sophistication and have to get the selection approved by a committee. Of course, that varies; it wouldn't be the case in a large corporation.

So yes, we're starting to investigate who the pension plan audience is, which of our general public and upscale public messages work with that audience, and how to differentiate our messages to the less sophisticated and the more sophisticated people out there. Again, we have to do it a bit by proxy, because we're a little uncomfortable bringing the actual sponsors into our offices to be in focus groups.

MR. CORWIN: I think that the insurers, as they promote themselves through advertising and other public relations efforts, need to emphasize that they are in the business of issuing promises and keeping them in the long run. Therefore, it's imperative for companies to make sure that they are of the highest possible quality. They should be viewed as triple-A and promote that standing, so that the public knows that that's how insurers act.

MR. ALISTAIR NEILL*: We had a lot of trouble in Britain during the Persian Gulf crisis, because insurance companies wouldn't insure military personnel who wanted to take out new policies when they were called to go to the Gulf. A lot of the press thought that insurance companies were being unpatriotic and that they should have taken any loss out of their profits.

Another thing I'm bothered about is that I know nothing about these rating calculations that your colleagues have been doing and Standard & Poor's is about to start up in my country.

MR. FILLINGHAM: In whatever dealings you may have with Standard & Poor's, you will do best if it is clear to everyone that your company is indeed committed to keeping the promises it makes.

MR. BOOTH: Obtaining a rating may be a fairly expensive process, because there are in-depth interviews. One rating service has given ratings without the in-depth interviews and without a charge, but those ratings appear to be lower than those for

* Mr. Neill, not a member of the Society, is General Manager of the Scottish Widows' Fund in Edinburgh, Scotland.

which a fee is paid. This has provoked considerable consternation within the industry in the United States.

MR. DANIEL F. CASE: With regard to the Gulf war, there is legislation in Virginia, where there are a number of military installations. A bill was enacted that prohibits refusing to issue a life insurance policy on account of military status or duty assignment. That is the only bill, of several that were enacted in various states, that seems to have an impact.

MR. BOOTH: As the Virginia bill moved forward, the reports were that it was unstoppable; that it would be like standing in the way of patriotism to oppose that bill. There was an interesting spillover: a proposal to amend Missouri law and a National Association of Insurance Commissioners (NAIC) model law to bar rejecting an applicant for insurance on the basis of lawful occupation, military or nonmilitary.

MR. WALTER S. RUGLAND: I'd like Bob's reaction to the suggestion from North Dakota Insurance Commissioner Pomeroy that there needs to be a body regulating rating services and that the NAIC should do that with respect to life insurance. I think his point is that the rating services exert an external force on expected cash flows of life insurance companies and can have a significant effect on whether a company can operate within statutory requirements.

MR. FILLINGHAM: There is a relationship between the Securities and Exchange Commission (SEC) and the bond-rating services – not A.M. Best Company and Weiss – in the sense that they are registered investment advisers. I think that to have a regulatory structure in which rating services are obliged to comply with certain standards would be perfectly appropriate. I don't know whether Moody's, Standard & Poor's, and Duff and Phelps would continue to work in the insurance industry in that event. It's just been a natural extension of the service that they've been providing to investors. Some of them might find any standards imposed by some new regulatory agency to be so confining or so inconsistent with the style in which they wanted to conduct their business that they would withdraw. But, certainly, I think it would be good to have standards that would make it more difficult for other firms to come along and, without much rhyme or reason, put together an opportunistic rating system that could do a lot of damage.

MR. BOOTH: Bob, you mentioned that the SEC looks at Moody's and others as investment advisers, presumably with respect to the bond ratings. Does the SEC look at claims-paying-ability ratings, too?

MR. FILLINGHAM: I believe it looks only at the debt ratings. I think those are the only ratings with respect to which it would see itself as having a role.

MR. BOOTH: So it could, possibly, be argued that the NAIC might have a comparable role in the claims-paying-ability rating?

MR. FILLINGHAM: Yes.

MS. APRIL A. HOLDUN-HUNT: A lot has been said about the image of the life insurance industry and how it needs to be enhanced. My company has done a lot to help our community: raising money for the United Way, having walks and runs to raise money to fight muscular dystrophy, helping promote certain programs for the Public Broadcasting System. Perhaps, if we focus some publicity on the good that we give back to our communities, it might help our image.

DR. PERLMAN: We've just done a series of investigations of that issue in our MAP program. I agree, it is helpful for the life insurance industry to undertake a variety of community activities. People are particularly receptive to those that relate to our bottom line, like working on AIDS and drunk driving. One caution: we don't fare as well when we try to tell people what wonderful things we do. People perceive it as patting ourselves on the back, and it loses credibility. But if you just go ahead and do the work in your community, and people see you doing it, then it can have a very positive effect.

MR. BOOTH: The ACLI and the Health Insurance Association of America (HIAA) jointly run an organization called The Center for Corporate Public Involvement. It coordinates many community activities and other charitable enterprises of member companies. Any of you who are from companies that may not be aware of this may want to have your companies write to the ACLI or HIAA to find out about this activity.

MS. SARAH L. M. CHRISTIANSEN: My company runs a United Way campaign, and this year's goal is $600,000 from the employees, to be matched by the company.

On the subject of ratings, I would like Mr. Fillingham to comment on a statement that I heard. One of the reasons the rating services were lowering ratings was that they felt there was no such thing as a triple-A company, with respect to the claims-paying ability of insurers, or that maybe insurance was being too highly rated relative to banks and savings & loans.

MR. FILLINGHAM: I've never heard anyone say before that the rating services were lowering ratings because they didn't believe there should be such a thing as a triple-A rating.