



# The Universal Life Insurance Policy

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*Editor's note: This issue of EMPHASIS breaks with tradition, since it represents not the collective view of the staff of Tillinghast & Company but the outlook of an individual staff member. James C. H. Anderson, president of the firm, presented the paper from which this article is taken before the Seventh Pacific Insurance Conference in September 1975. Mr. Anderson's approach is provocative, and his perceptions may be controversial to some; but, in the current climate of concern over the future of the life insurance industry's traditional products and distribution systems, they deserve careful consideration. Here, then, is one man's blueprint for a "universal" life insurance policy — for what the author calls "a fully flexible alternative to conventional life insurance contracts, designed to meet the needs and demands of the life insurance market in 1975 and beyond."*

## Purpose and Scope

The purpose of this paper is not to present a revolutionary new concept; instead, it is to reexamine a familiar concept in the light of new market circumstances and to consider the consequences to the life insurance industry if the concept were adopted.

In summary, this paper advances the following arguments:

... that it is no longer realistic to assume that the typical life insurance buyer is one who will, for an extended period of time, remain married to the same wife, work at the same job and live in the same house situated in the same city; or that the financial security needs of this typical buyer and his ability to pay for them will remain constant and can be expressed in constant nominal dollars.

... that it is not realistic for the industry to address the needs of the typical buyer with traditional permanent life insurance products requiring fixed regular premiums and providing fixed benefits, both expressed in constant nominal dollars.

... that the traditional life insurance industry distribution and administrative systems are excessively and unnecessarily costly and place the industry at a competitive disadvantage by comparison with other savings media.

... that the industry should respond to the needs of the contemporary market by introducing a simplified, flexible and less costly product.

... that the introduction of such a product is technically and financially feasible if a more effective distribution system can concurrently be developed.

... that the introduction of such a product would probably have a serious and adverse initial impact on

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the life insurance industry and its existing distribution systems.

... that, notwithstanding the foreseen difficulties, the needs and demands of the market will lead to the introduction of such a product, possibly led by companies with no commitment to traditional distribution systems, and that the eventual result will be more favorable to the life insurance industry than the only realistic alternative — an all-term industry.

Obviously, these are sweeping arguments and they imply nothing less than a coming revolution within the life insurance industry. The limited scope of this paper does not permit their full development, nor does it permit adequate consideration of counterarguments. This paper is intended to apply to the individual financial security market and general environment of the United States; its application to other countries of the Pacific Rim is limited, sometimes significantly, by differences in the environment.

## The Market in 1975 and Beyond

What are the important differences between contemporary market conditions and those of the past? Much could be said on the subject of changed and changing market conditions; so much, in fact, that it is essential to limit this review to an identification of those continuing changes most likely to impact the life insurance industry, its products and its distribution systems.

First, there are the changes of a social nature. Changes in attitudes toward marriage and the family are perhaps the most fundamental of these. These changes are manifested in an increase in the number of single and divorced persons and a decrease in the number of children in the average family. Frequent change of employment, often accompanied by relocation, also is a characteristic of contemporary society. Changes are apparent in social attitudes which play an important role in motivating people to provide for their own and their families' financial security: evidence of a decline in the desire for self-reliance can be seen in the increasing dependence upon employer-sponsored and Government-sponsored financial security programs. Changes are also apparent in public confidence in institutions ranging from Government to financial companies which must depreciate the value attached to long-term contractual promises such as life insurance policies. Notable changes have occurred in the general level of education of the public at large (accompanied, arguably, by an

associated increase in their ability to evaluate critically the insurance industry, its products and their cost).

Second, there are the changes of an economic nature. Perhaps the most important of these is the significant increase in family income levels, contributed to by the growing economic importance of working women and the associated trend toward two income families; clearly, the typical family today can afford and needs more financial security products than ever before. Major changes are also apparent in the much higher interest rates prevalent today and in the accelerated rate of inflation, both of which impact the motivation to save and the choice of savings vehicle. Finally, there is the much increased complexity and interdependence of all economic activities, with increased risk of instability and economic dislocation, an example of which is the present high level of unemployment.

Third, there are the changes relating to the industry itself. Competition for savings among various financial institutions has intensified. The recent and continuing experience of the life insurance industry with increasing policy loans and the recent experience of the thrift institutions with disintermediation have raised new problems in the area of investment management for both kinds of institutions, and have adversely affected their competitive position in the savings market. Except on tax-qualified products, life insurance companies are at a competitive disadvantage because the progressively increasing tax burden on investment earnings is effectively borne by policyholders; unless legislative relief is obtained, this trend will accelerate as the 10-for-1 rule is applied to progressively wider differentials between earned and valuation rates.

Outdated legislation relating to minimum reserves and nonforfeiture values has also limited the extent to which higher interest rates can be reflected in lower premiums on non-participating life insurance. Maintenance expenses, which have remained stable for many years despite inflationary pressures, are now rising significantly as the rate of inflation has over-taken economies of scale and computerization; if present trends continue, as seems likely, this will become a major industry problem.

Fourth, there are the changes of a political nature. Government-sponsored benefits have increased dramatically in both scale and scope and now include built-in inflation adjustments which ensure that the increases will continue for the foreseeable future. Consumer and environmental interests of an organized nature represent

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a major new political force which has already altered national priorities and now threatens directly to affect the life insurance industry. The traditional gap between political and economic logic is widening. One major consequence of these political changes is increased levels of taxation — particularly Social Security, state and local taxes.

How, then, can the resultant market environment in 1975 and beyond be described? In summary, it is one in which family and financial circumstances can be expected to change more frequently and more extensively than in the past; a market more sophisticated and more cynical than its predecessors; a market with increased need for financial security products and increased ability to pay for them; an increasingly competitive market, particularly as related to other savings media; a market in which long-term commitments are substantially affected by inflation; a market in which life insurance companies are subject to growing financial pressures arising from consumer interests, unreasonable taxes, increasing maintenance expenses, and outdated legislation; a market in which further Government intervention is to be expected, along with steady pressures for increased taxation of both policyholder and shareholder earnings.

## Traditional Products and Distribution

Having reviewed the factors affecting the contemporary life insurance market, it is appropriate next to examine the way in which the industry today addresses the market.

Overwhelmingly, the majority of financial security products sold to individuals by the life insurance industry are of the traditional type, characterized by the requirement of regular premiums of a fixed dollar amount and providing benefits of a fixed dollar amount. Most of the premium income arising from current sales will relate to permanent forms of life insurance. With few exceptions, these products are not responsive to changing circumstances. The multiplicity of plans, issue ages, rate tables, dividend scales, and nonforfeiture values create a vast array of unique cells, each a stereotype, which lends itself only tortuously to change by conversion to another stereotype with similar characteristics. Limited flexibility is afforded, but rather clumsily, by such features as premium and policy loans,

nonforfeiture options, conversion rights and various optional attached benefits. Although policies offering increasing or decreasing benefits and policies requiring increasing or decreasing premiums are available, these are merely additional stereotypes which attempt to anticipate future financial needs and ability to pay, generally unsuccessfully. Too often, flexibility is expensively achieved by lapsing one stereotyped policy which has outlived its usefulness, sometimes replacing it with another stereotype which also will outlive its usefulness.

Considering the implications of inflation alone, it is clear that permanent life insurance products requiring fixed-dollar premiums and providing fixed dollar benefits are of limited value. Examine the case of a 25-year-old buyer with a young and growing family and an annual income of \$10,000. Assuming only an annual productivity gain of 2%, he might expect an equivalent income at age 55 of \$18,000; but if inflation should continue throughout that period at a rate of only 5%, his nominal annual income at age 55 would be \$78,000. Does fixed-premium, fixed benefit, permanent life insurance have any relevance to this potential buyer's financial requirements over 30 years, even disregarding the major consequences of changing family circumstances, unemployment, or substantially greater increases in real earnings (all of which are more likely to occur than not)?

The life insurance industry markets its traditional products through its traditional distribution systems. The composition of these systems generally includes the soliciting agent, managers or general agents and supporting field staff. Although it is not easy to distinguish between full-time and part-time agents, it is clear that the sales frequency is quite low: probably on the order of 50 sales per year by the full-time equivalent agent of minimum acceptable standards. It is also clear that the costs of these distribution systems are quite high: for a typical mixture of individual business, a cost of 100% of first-year premiums and 7½% of renewal premiums would probably be representative of the experience of medium-to-large companies; many companies experience higher rates. Depending upon the assumed persistency experience and the rate of interest used to redistribute first-year costs, the equivalent level annual cost of the distribution system is in the range of 20% to 25% of expected premiums.

Traditional life insurance products and distribution systems are also expensive to administer. On average,

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for medium-to-large companies, head office acquisition and overhead expenses of 50% of first-year premiums and maintenance expenses of 5% of all premiums would be representative, with an equivalent level annual cost in the range of 12½% to 15% of expected premiums. Moreover, most policyholders own more than one policy and incur multiple maintenance costs.

Although the cost levels cited may be arguable and will vary, perhaps significantly, from company to company, the indicated equivalent level cost is in the range of 32½% to 40% of expected premiums, to which must be added at least 2½% to cover premium taxes, resulting in aggregate costs in the range of 35% to 42½% of expected premiums.

Although such an expense level, or even a higher level, is probably acceptable on the protection element of the premium, it compares most unfavorably with cost levels incurred by competing savings media unless substantial tax advantages not available on competing media are afforded to the policyholder as an offset to these costs.

One form of traditional life insurance warrants special mention: term insurance. Although term products are also stereotypes, they afford greater flexibility than permanent forms, at least for those who remain insurable; and cost levels are acceptable even to those who terminate early. Notwithstanding powerful counter-incentives afforded by typical commission scales, term insurance continues to capture an increasing share of the life insurance market.

It should be noted that not all of the products offered by the life insurance industry require regular fixed-dollar premiums and provide fixed-dollar benefits, nor are all types of products subject to the cost levels cited above. The Minnesota Mutual Life Insurance Company has for three years been marketing a type of "life-cycle" policy which it calls "Adjustable Life." The Minnesota Mutual plan is one which permits an adjustment of premium levels through a variation in the mix of term-type and permanent-type coverage. The face amount of the policy can also be increased or decreased but, once established, premiums and benefits remain fixed until another change is made. Another type of contract which has recently acquired considerable prominence is the flexible premium annuity which is used in the sale of tax-sheltered annuities and individual retirement accounts. These are generally simple accumulation plans which afford complete flexibility in the amount and interval of premium payment. Most variable annu-

ities are a form of flexible premium annuity where the accumulation is based on the investment results of a unitized separate account. A few companies have introduced policies which contain cost-of-living adjustments, but these have not met with widespread success due, perhaps, to the conservative pricing bases which underlie them. With the exception of flexible premium annuities, which provide substantially lower commissions, these new products continue to be sold through the traditional distribution systems at traditional cost levels.

In summary, the industry response to the needs of the contemporary life insurance market has thus far involved no fundamental change in its traditional products and distribution systems, which are not well suited to the market's characteristics. Considering the cost levels involved in the distribution and the administration of these products, it appears unlikely that the industry can expect to maintain its share of the savings market; and a continued diminution of its market share seems more likely than not. Thus far, the industry response to the need for more flexible products has been quite limited; what new products have been introduced continue to be distributed and administered in the traditional manner.

## Ideal Product Characteristics

Given the foregoing perception of the contemporary life insurance market, what are the characteristics of the product best suited to the needs and demands of that market?

The overriding need is for *flexibility*. At a minimum, the buyer should have the right to maintain his insurance protection intact, notwithstanding inflation. Ideally, he should be able to adjust his insurance protection upward or downward at any time, subject to reasonable conditions and without unreasonable cost or penalty. He should be able to make premium payments at his convenience, including the right to make lump-sum payments and to suspend payments, even for extended periods of time.

The next most important requirement is for substantial cost reductions as related to the savings element of the contract. To achieve this, a significant increase in the effectiveness of the distribution system is required, together with a major simplification of the product and the required administrative systems.

To increase the investment return on the savings element to competitive levels, to reduce federal income taxes levied on policyholder accumulations and to avoid

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problems arising from unreasonable requirements relating to nonforfeiture values and reserves, the ideal contract should be of the accumulation type. It should provide a guaranteed investment return limited to the statutory valuation interest rate, with a provision for payment of excess interest on a basis taxable to the policyholder and deductible without limit by the company. Thus, the form of contract indicated for the savings element resembles a flexible premium annuity with taxable excess interest credits (this may also afford premium tax savings in states which have lower tax rates for annuities).

The ideal contract must provide reasonable short-term benefits, even if payment is suspended in year one. For early suspensions, it is probably not practical to provide cash benefits, but extension of coverage probably is practical.

The ideal contract must realistically recognize economies of scale, but without attendant complications. This inevitably leads to the corollary that very small contracts cannot economically be sold on a compatible basis.

In summary, the characteristics of the ideal contract for the contemporary market are flexibility, reduced cost, simplicity and tax efficiency.

## The Universal Life Insurance Policy

A specific product design possessing the characteristics described in the foregoing section is offered for purposes of discussion.

*General Description:* A flexible-premium annuity with a monthly renewable term insurance rider.

*Loadings:* Payments to the annuity are subject to a deduction ("load") of 10% of the first \$5,000 of accumulative premium and 5% of excess amounts, plus applicable premium taxes. Maximum renewal term life premiums are equal to valuation net premiums (life and disability) to avoid deficiency reserves; the company's current rates (presumably lower) would actually be charged. For the first month the term premium is \$1.00 per \$1,000 greater.

*Initial Premium:* Minimum initial premium is \$250 plus \$1.00 per \$1,000 initial amount of term life insurance.

*Renewal Premiums:* Subsequent premiums for the annuity may be paid at any time, subject to a minimum of \$100. Regular payments by preauthorized check are

subject to a minimum of \$25. Term insurance premiums are paid only by withdrawal from the annuity fund.

*Accumulation Basis:* Annuity payments (less load and applicable premium taxes) are accumulated at a guaranteed interest rate of 4% (where equal to the maximum valuation interest rate) on amounts in excess of \$250 (interest earned on the first \$250 or less offsets maintenance expenses); excess interest is paid at the discretion of the company and is reported as such for tax purposes (thus permitting payment of gross interest).

*Renewal Dating:* Term life insurance will renew on a calendar-month basis with a pro-rata premium (plus \$1.00 per \$1,000) payable for the first calendar month.

*Surrender Charge:* A surrender charge of 5% of the amount by which the cumulative payments are less than \$5,000 will apply.

*Loans and Withdrawals:* Policy loans are not available; a partial withdrawal may be made, but not less than \$250 must remain in the annuity account.

*Amounts of Insurance:* Level amounts of term life insurance will apply prior to age 65, with automatic indexation available (CPI-based); at and after age 65, term life benefit reduces 1/35th of the level amount annually (indexing continues) and expires at age 100. Amounts of insurance may be decreased or, subject to evidence of insurability and a charge of \$1.00 per \$1,000 additional insurance, increased at any time.

*Nonforfeiture Benefits:* None; contract terminates 30 days after annuity fund is exhausted (this is to satisfy grace-period requirements).

*Waiver of Premium:* Term insurance premium is waived during total and permanent disability commencing prior to age 65 (three-month waiting period).

*Multiple Lives:* Term riders covering dependents are available on the same terms and may later be transferred to another annuity contract without evidence of insurability.

*Existing Policies:* Existing term and permanent policies may be converted without evidence of insurability by applying cash values to the annuity contract and effecting term life insurance for the net amount at risk under all contracts. Cash values so applied are subject to no load and are included in the accumulative premium to determine subsequent loads. Term insurance is issued at renewal premium rates.

*Annual Statements:* Policyholders will be furnished an annual statement on a calendar-year basis.

The foregoing is only one approach to the design of a contract with the desired characteristics. There is ample

scope for variations in the form of the term life insurance, the loading pattern, the accumulation process, the availability of optional benefits and other features. It should be noted that the suggested design can provide any conceivable pattern of premium payment and coverage and thus can replace all other products. Hence, the Universal Life Insurance Policy.

It appears that the Universal Life Insurance Policy could be sold under existing regulation, although minor changes might be necessary in the suggested surrender charges on smaller policies to meet minimum cash value requirements in some states. There are also several unresolved questions relating to reserve requirements on flexible-premium contracts, and questions might arise as to the proper treatment of the proposed contract for purposes of determining applicable state premium taxes and federal income taxes. None of these regulatory uncertainties appears to be a major impediment to the introduction of the proposed contract.

## Financial Considerations

Is the Universal Life Insurance Policy feasible from a financial viewpoint? To answer this question, pricing and profitability tests have been performed. They indicate that the answer is affirmative.

The pricing and profitability tests examine three cases: the profitability of the annuity standing alone; the competitiveness of the required term insurance premiums; and the profitability of no-load conversions of existing policies with allowance for payment of standard commissions. The results of the tests indicate that the proposed product is feasible, provided the company retains a 1% interest margin and provided the other underlying assumptions are realized. Several of the assumptions relate to areas where little or no experience exists or where the nature of the product is expected to alter typical experience; these deserve particular attention.

The assumed average premium is \$500 for the first year; although this is higher than experienced on typical life insurance sales, the nature of the product and the minimum initial premium of \$250 would tend to encourage higher premiums. In subsequent years, for those who do not suspend payment, it is assumed that premiums increase at a rate of 5% annually.

The assumed net suspension rates are comparable to the lapse rates which might be expected on life insurance business of reasonably good quality. The nature of the product, particularly the aspect of voluntary pre-

mium payment, might lead to higher suspension rates, especially in the early policy years; against this must be weighed the effect of resumed payments on previously suspended policies, which could lead to a near-zero net suspension rate in later policy years. It is also assumed that 50% of current net suspensions and 10% of previously suspended policies are surrendered each year and that partial withdrawals are equal to investment earnings credited. Although industry experience with other flexible premium contracts may not be closely comparable, judged by that standard the assumed suspension rates are rather optimistic and the assumed surrender and partial withdrawal rates are somewhat pessimistic.

Probably the most crucial of the assumptions are those relating to expenses. Maintenance expenses are assumed to be offset by investment earnings on the first \$250 of accumulated funds; this allowance is comparable to maintenance expenses incurred on traditional life insurance products, and is probably adequate; the added cost of monthly premium accounting and annual statements to policyholders is offset by simplified accounting and the absence of premium notices. Initial processing and issue expenses are assumed to be \$50 per policy, which is comparable to industry experience. Underwriting expenses are assumed to be offset by select mortality savings, which is probably an adequate, if simplistic, assumption. The controversial expense assumptions are those relating to distribution and overhead costs.

If the product is to be distributed through a traditional agency system, it is assumed that compensation to the soliciting agent is \$100 per contract, 50¢ per \$1,000 initial amount of insurance and 2½% of all premiums paid. For various first-year premiums and amounts of insurance, this translates into the following equivalent first-year commission rates:

First-Year Premium	Initial Amount of Insurance	First-Year Commission	Commission Rate
\$ 300	\$ -0-	\$107.50	35.8%
	30,000	122.50	40.8
500	-0-	112.50	22.5
	50,000	137.50	27.5
1,000	-0-	125.00	12.5
	100,000	175.00	17.5
1,500	-0-	137.50	9.2
	150,000	212.50	14.2

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Clearly, these commission rates are very low in comparison with rates on traditional life insurance products, particularly for larger premiums. The suggested level of soliciting agent compensation is practical only if sales frequency increases substantially (an increase of 100% is probably required to maintain agent earnings at traditional levels).

Other sales and overhead expenses are assumed to be 100% of total agents' compensation. This is quite close to current industry experience, if other sales and overhead expenses are expressed as a function of agents' compensation. To the extent that such expenses relate to the management of the agency organization, as seems reasonable, the relationship between such expenses and aggregate agent compensation should not be significantly affected by the assumed increase in sales frequency.

Although the appropriateness of various of the assumptions may be argued, the central issue relates to the assumed level of distribution costs and the implication that agent productivity can be increased as required to maintain current income levels. Alternatively, the product might be distributed in an entirely different manner (for example, by a bank) at the cost levels suggested. Considering the distribution costs of other financial security products, such as mutual funds and savings accounts, it appears more likely than not that the suggested cost levels can be achieved, one way or the other. It is recognized that existing agency organizations would strongly resist the proposed compensation basis; this suggests that an entirely new distribution system might be required and, if that is the case, suggests also that companies sponsored by non-traditional interests are more likely to accept the suggested concept than are established life insurance companies with substantial financial (and emotional) commitments to their existing distribution systems.

In summary, the financial viability of the proposed product is primarily dependent upon the development of a distribution system which is much more efficient than traditional life insurance distribution systems. The balance of evidence, largely the experience of other industries, suggests that the development of such a distribution system at the cost levels assumed is practical.

## Implications for the Industry

What would be the impact on the life insurance industry of the successful introduction of the Universal Life Insurance Policy? What practical considerations

would affect the manner of introduction of such a product and its likely success? How would the industry respond? To suggest answers to these questions, the following scenario is offered:

*Cannibal Life is a medium-size stock life insurance company owned by a powerful non-financial company. Its management and that of its parent company are aggressive and non-traditional; its agency organization is traditional and commission-oriented.*

*At the urging of its parent company, Cannibal Life decides to adopt a completely new marketing strategy designed to achieve major market penetration. It decides to withdraw all currently issued life insurance plans and to offer only the Universal Life Insurance Policy, notwithstanding the risk of losing its entire agency organization. It decides that it will make a conversion offer to all existing policyholders. Furthermore, it decides to take the unprecedented step of offering to convert, without evidence of insurability, life insurance policies issued by other companies on the same terms as are being offered to its own policyholders. Although a no-load offer is to be made both to its own policyholders and to policyholders of other companies, Cannibal Life intends to pay commissions on such conversions at the usual rates. Existing policyholders are to be notified that they can consolidate all of their life insurance policies with all companies into one Universal Life Insurance Policy. Cannibal Life intends to support its marketing strategy through an aggressive public relations and advertising program, particularly including efforts to enlist the sympathy of activist consumer groups; this is a vital aspect of the marketing strategy, as will later appear.*

*The new marketing strategy is unveiled to the agency organization and launched with great public fanfare. Company representatives call press conferences and appear with consumer activists on television interview programs; their comments regarding traditional life insurance products are not kind. Notwithstanding the radical reduction in commission rates, the agency organization is enthusiastic because of the income opportunities afforded by the conversion program and the confidence generated by widespread publicity. The conversion program is highly successful and Cannibal Life's expectation that business in force would increase by 100% within one year is surpassed; on average, each of its own policyholders converts one additional policy issued by another company and many policyholders of other companies also convert their policies.*

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Although the profitability of the new contract is significantly lower than that of existing business, Cannibal Life is able to increase its aggregate GAAP earnings on the increased volume of business (previously capitalized acquisition expenses are charged off as an extraordinary item). Its agency organization also prospers and grows. Large statutory losses are incurred, but these are absorbed by tax recoveries and by a substantial infusion of capital from the parent company.

Cannibal Life realizes that the conversion program is not a permanent source of new business. As a follow-up strategy, Cannibal Life decides to mount a major effort to capture a large share of the juvenile market by offering a special variation of the Universal Life Insurance Policy specifically tailored to the needs of this market. The sales program promotes the product as "The Only Life Insurance Policy Your Child Will Ever Need." Because premiums on the juvenile plan are relatively low and commissions are relatively high, the reception by the agency organization is again enthusiastic and the customer base of Cannibal Life is greatly expanded, thus ensuring a future flow of business. Cannibal Life also decides to mass-market its new contract through employers and associations and, for this purpose, undertakes to develop a specialized agency organization which, in the long term, becomes its principal source of new customers. Eventually, its original agency organization will be disbanded and replaced by a new service-oriented organization designed to maintain its established customer relationships; this organization will be composed primarily of women. The new marketing strategy is a huge success, and Cannibal Life becomes a market leader in the individual insurance business.

The activities of Cannibal Life do not go unnoticed. Through regulatory agencies, life insurance industry and agent associations attempt to block Cannibal Life's conversion program, but these efforts are unsuccessful due largely to the public outcry by activist consumer groups. A temporary injunction is obtained against Cannibal Life, but the request for a permanent injunction is denied; in its opinion, the Court observes, "To grant the relief sought would be tantamount to accepting the view that a class action suit on behalf of mousetrap makers against the maker of a better mousetrap is valid." The Court decision receives the attention of the national media, including network television. Cannibal Life receives large numbers of applications for employment from agents of other companies, many of whom

are hired. Conversions of other companies' policies increase dramatically.

The activities of Cannibal Life also attract the attention of four national retail organizations, all of which are already engaged in financial service businesses; these companies decide to introduce similar products and to market them on a non-agency basis through retail outlets. Similar action, based on a direct mail approach, is taken by the sponsors of two nationally recognized credit cards. Several life insurance companies of various sizes, including one sponsored by a credit union association, adopt a marketing strategy similar to that of Cannibal Life. All of these ventures are reasonably successful.

The impact upon the rest of the life insurance industry is now quite severe. A major decline in sales is experienced, accompanied by a substantial loss of agency manpower, leading to a further decline in sales. Surrenders increase to the extent of causing a negative cash flow. Investment losses are incurred on the liquidation of investments to meet cash flow requirements; to minimize investment losses, higher-yielding assets are sold and portfolio investment returns decline. The loss of sales and business in force and the reduced investment returns cause an expense and earnings crisis which is temporarily masked by large surrender profits under statutory accounting. Most stock life insurance companies report GAAP losses due to the writeoff of unrecoverable deferred acquisition expenses. Mutual companies are forced to reduce dividends. Life insurance company share prices fall precipitously. Due to the decrease in business and the associated reversal of the effect of certain tax elections, most companies incur substantially increased federal income taxes on current income and some companies are subject to Phase III taxes on prior years' income previously deferred. Some companies decide to suspend writing business to avoid insolvency and there are numerous consolidations within the industry involving both stock and mutual companies.

Eventually, the surviving companies also introduce similar products and adopt similar marketing strategies. Gradually, stability returns to the industry, but market shares within the industry are substantially and permanently rearranged and the distribution systems are fundamentally altered. Following a period of adjustment, industry penetration of the individual savings market increases to record levels.



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Is this scenario a real possibility? Are the Cannibals really coming? And does the story really have a happy ending? It is right to be skeptical of both Doomsday talk and happy endings; but not always right. Consider what has happened in the mutual fund industry within the past 10 years: how many retail funds of yesteryear are dealer or no-load funds today? Can similarly revolutionary changes happen in the life insurance industry? And happen as quickly?

No industry, regardless of how well entrenched, is invulnerable to basic economic forces; it must offer a product or service that the public needs or wants, at a price the public is prepared to pay. The life insurance industry offers a unique product that the public needs and wants and for which it is prepared to pay current prices and, arguably, even higher prices. The product is term life insurance, whether sold alone or in combination with a savings plan. Unfortunately, the majority of the income of the life insurance industry (and especially that of its distribution system) arises from amounts paid for life insurance policies over and above an appropriate price for the term life insurance provided (i.e., the savings element). Thus, the industry is primarily dependent for its income on its role in the savings business and there it has no product monopoly and a seriously disadvantageous competitive position. Of course, this problem is not new but, due to changes in the market environment, notably the increase in inflation rates and in public awareness, the problem is now more widely recognized. These are the circumstances that argue for revolutionary change.

## Evaluation and Conclusions

If revolution is to come, should it be welcomed or resisted? Will it damage an established industry to the point of no repair, or will it forestall the even more destructive evolution which has been in progress for many years? It is the view of the author that the life insurance industry either will remain in the individual savings market on a sensible economic basis, or will be forced to withdraw from the individual savings market

altogether and confine its activities to underwriting term insurance and a limited number of other specialized products. The case for the first alternative has already been argued; the case for the second can be argued simply by pointing to established trends and to the examples of various countries where endemic inflation has led to the practical disappearance of all permanent life insurance, accompanied by severe changes in industry economics. Given only these two alternatives, it seems clear that the less destructive and more promising is the first, leading to the conclusion that the revolution should be welcomed.

Given this conclusion, it remains to be seen who the Cannibals and their victims will be. As the scenario suggests, those who are prepared to lead the revolution are likely to emerge from it in a greatly strengthened position, while the last to follow will suffer the most and may even not survive.

As stated at the outset, this paper is intended to apply to the individual financial security market and general environment of the United States. Its application to other countries would be affected by differences in industry economics, regulation, taxation and other factors. Particularly in those countries where life insurance enjoys special tax concessions are the differences likely to be significant.

## Acknowledgements

Many persons have contributed to the ideas and views assembled in this paper. The basic concepts underlying the Universal Life Insurance Policy have been advanced before by many others. The most striking example that has come to the author's attention was a presentation made several years ago by G. R. Dinney, F.S.A., F.C.I.A., to the Canadian Institute of Actuaries, entitled *A Descent into the Maelstrom of the Insurance Future*, which argued many of the same views and even included a description of a product entitled "Universal Life Plan."

