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NEW PRODUCT IDEAS FROM AROUND THE WORLD

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A sharing of ideas, skills, and techniques for new products and their distribution among different countries.

MS. PAMELA M. CRANE: We have Marc Slutzky, who recently joined Tillinghast's Stamford office. Prior to that, he spent 13 years with The Equitable Life Assurance Society, most recently working on Equitable's demutualization as well as their year-end cash-flow testing. However, the experience that brings him to this panel is the fact that from 1988 to 1991 he was in Tokyo as the chief financial officer of Equitable's Japanese subsidiary, the pronunciation of which I can't properly execute and therefore I'll leave that to him.

David Gulland is a consultant with Bacon & Woodrow, one of the preeminent consulting firms in the U.K. He is a Fellow of the Institute of Actuaries. David has worked on product development and product design projects for a number of companies in the U.K. He is also a member of Bacon & Woodrow's European insurance team and has recently been involved with product development projects in both Belgium and Italy as well as working on the demutualization of the Danish state-owned life insurance company.

Well, this discussion purports to be about new product ideas from around the world and much like Jules Verne's hero, Phineas Fogg, who went around the world in 80 days, we're going to try to take you around the world in 80 minutes or less.

I think we're going to proceed by traveling west around the globe, so off we go, across the U.S., across the Pacific Ocean and to Marc Slutzky who will speak to you primarily about Japan and to a lesser extent about the Pacific rim in general.

MR. MARC SLUTZKY: As with pre-1992 Europe, the Far East is distinguished by a multiplicity of markets and regulatory environments as well as countries in vastly different stages of economic development. In discussing their markets, it's useful to segment the countries into four groups depending on their economic classification.

The first group consists of Japan alone. Relative to the remainder of the Far East, Japan dominates in terms of GNP, insurance premiums, and stock market capitalization.

Financial services in Japan are driven primarily by four factors: a high rate of individual savings, low taxation of capital gains on stocks, relatively conservative regulation with close relationships between government and industry, and an industry that is

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traditionally dominated by relatively few large corporations with many close relations with other large firms. The insurance market in Japan is a good example of this last factor.

Life insurance and property and casualty insurance are not nearly as fragmented as in either the U.S. or in Europe. There are 30 life companies doing business in Japan as compared with thousands in the U.S.; similar statistics hold in the property and casualty (P&C) industry. The result is that the Japanese companies are very large in comparison with U.S. companies. Furthermore, each of the largest companies has extensive relationships with other companies within their corporate groups giving them an easily penetrable market for their products.

Since corporate pension plans are relatively new and pay less than would be needed to finance retirement, insurance plans tend to focus on savings, emphasizing whole life and endowments over term insurance. Individual annuities are also a rapidly growing segment of the market as more Japanese become members of the aging society.

Regulation in Japan is largely a cooperative exercise between the Ministry of Finance and the Life Insurance Association of Japan. This helps the largest companies wield considerable influence over the entire marketplace. Japanese companies tend to offer similar products with limited competition.

The second grouping of countries are the four so-called tigers, namely, South Korea, Taiwan, Hong Kong, and Singapore. While these countries generally show many similarities to Japan (for instance, there are relatively few domestic companies which dominate within each financial service industry), cooperation between government and industry is close and the savings rate is high. Each of these countries has characteristics which distinguish it from the others.

Measured by population, South Korea is the largest of these countries. It is important not to confuse Korea with Japan although the Koreans have clearly taken several pages from the Japanese book. The Korean market is not nearly as advanced as Japan within the life industry, and it is characterized by relatively high lapse rates. Furthermore, the potential for consumer unrest has been high in the past with instances of strikes by employees of foreign life companies accompanied by threats of violence against foreign managers. In all probability, Korea will turn out to be a profitable market for financial services in the future although a local partner will probably be a requirement for success.

Taiwan is somewhat similar to Korea in its development. The life industry is recently opening up while the remainder of the industry is still developing. Regulation of these industries is quite close with the government acting in a protective mode towards local companies.

Singapore is the smallest of the tigers. While its stock exchange is active, other financial services opportunities are limited due to the small population. However, Singapore is frequently used as a staging point for the remainder of Southeast Asia.

Hong Kong is different from the other tigers in several ways. Its financial services industry is essentially open with limited or lax regulation. The stock market crash in 1987 brought many abuses into the open, but it's safe to say that not all have been corrected as of today. Second, the agreement between the U.K. and the People's Republic of China (PRC) to return Hong Kong to the PRC has created an uncertainty which will not disappear until after the combination in 1997. Nevertheless, Hong Kong has been and continues to be a center for investment in the entire Pacific rim. There are well-developed life insurance and P&C industries as well as extensive banking and money management facilities in Hong Kong. Whether they represent an attractive opportunity, however, depends on your view of the PRC.

The next grouping is a single country, the PRC itself. There are more than one billion people in China, most of them very poor. However, there is a developing industrial base in the provinces near Hong Kong. But, with the addition of Hong Kong and the potential for a loosening of the reins once the current group of leaders leaves the scene, some companies are entering Hong Kong with the express purpose of having a window into China. Whether this will prove to be a good move will depend, of course, on what happens in the government.

The last group is, of course, everyone else. There are some countries in this group such as Thailand, Indonesia, and Malaysia where the economies are relatively advanced and financial services industries may start to grow soon. Others, like Vietnam and the Philippines, have economies in various stages of development and will require far more time to develop the necessary underpinnings for a successful financial services industry.

The Far East must be evaluated situation by situation. Despite talk of Japan creating a unified market, this is extremely unlikely. However, as all of these countries look at the experiences of Japan and for the less advanced countries, the tigers, and use them as prototypes for their own course of action, I believe we can expect, therefore, that these markets will continue to show the rapid growth that they have in the past and that they will gradually open their markets to foreign companies and products.

I'd like to use the example of Japan as the prototype. The size of the Japanese life insurance market exceeds that of the U.S. even though Japan's population is roughly half of the U.S. There's approximately $15 trillion of insurance in force in Japan as compared to $10 trillion in the U.S.

Japanese products are generally simpler than those in the U.S., and there are fewer companies in the marketplace. Products are generally of a traditional fixed benefit type, but variable life has a small share of the market, it is somewhat less than 5%. All products are scheduled premium. Universal life has not yet been permitted in Japan. Products are generally participating as all of the domestic companies are mutual. Foreign capital companies are stockholder-owned although some issue participating business.

The predominant products include whole life and endowment with recurring premium and single-premium endowment contracts. Individual annuities have been the fastest growing segment of the market with annual growth rates exceeding 20%. Although

only fixed-dollar annuities are being marketed currently, an industry group is studying the design and administration of variable annuities.

Life insurance is tax-favored in Japan. There is an estate tax exemption based upon the number of heirs for contracts other than single premium. Premiums on corporate-owned life insurance and endowments, as long as death benefits are payable to the employee's family, are 50% tax deductible to the corporation provided the plan is nondiscriminatory. In addition, interest on loans used to finance insurance purchases are tax deductible to the corporation.

Tax planning also drives the single-premium market. High taxes are imposed on the transfer of real estate at death. However, if the real estate is used as collateral for a loan, only the value in excess of the loan is included in the estate. If the loan proceeds are then used to purchase a single-premium life policy, the policy proceeds are partly tax exempt. In addition, interest on a loan is deductible if the borrower is a corporation or business.

In order to illustrate the processes and challenges of introducing new products in Japan, I'd like to discuss the process of introducing variable life insurance in Japan which occurred in the mid-1980s. Variable life was designed to take advantage of the high savings rate of the Japanese people and to meet the perceived changing needs of the aging society due to the relatively low level of government and private retirement benefits.

The term "aging society" is widely used in Japan and it means there is a significant increase in the proportion of the elderly Japanese population which is elderly and no longer working. This proportion was expected to grow rapidly at the same time that the society and economy were being transformed from its post-war reconstruction mode with emphasis on survival and sacrifice to the current well-developed mode.

Consumers needed products which would allow them to participate in the growth of the economy as well as to earn returns above the level that they had been receiving from the traditional fixed-dollar products. Additionally, they needed products that would allow them to invest their funds in overseas markets. Traditional Japanese life products were general account only. Within the class of noninsurance investment-type products, there was limited availability of mutual-fund-type vehicles and the returns on those funds were not considered to be truly market rates.

Product development is a slow process in Japan as compared to the U.S. Product design is generally uniform among companies with little competition in premium rates or dividend scales. Insurance is regulated by a division of the Banking Bureau within the Ministry of Finance and products must be approved by the government actuary. The government actuary often has not been a member of the Actuarial Society of Japan. This division has limited staff and does not have the time to study multiple product introductions; therefore, much of the product development work is done cooperatively by the industry through the Life Insurance Association of Japan (LIAJ).

Variable life insurance (VLI) was the first major product to be introduced in several years and was introduced after a long period of study. Several variants of variable life and endowment have been introduced in the last several years. Single-premium

variable endowment was introduced in late 1990 after three years of voluntary self-restraint by the life insurance industry to avoid cannibalizing their own single-premium fixed-endowment contracts and to avoid criticism by the securities industry.

The next major product innovation will likely be variable annuities as this is a product that will fill a need of the aging society and should be popular among Japanese consumers who are inclined towards savings. There is an industry committee currently studying product design and administration.

The industry also has been studying universal life for several years, but prospects for its introduction soon are uncertain as there does not appear to be a push from consumers or companies.

Entry into the life insurance industry has been difficult and licensing standards have been unclear, so competition from other companies has not led to significant new product introductions. However, with the coming deregulation of the financial marketplace, it is to be expected that there will be competition from other financial institutions and companies from other countries.

Several of their constraints and regulatory influences include the distribution system, which may serve as an informal barrier to entering the marketplace. A typical industry salesperson in Japan had been a housewife who did not have significant knowledge of financial products. Sales of new companies in VLI had often been constrained because of the need to train newly-hired representatives both to sell insurance and to pass the licensing exams for variable contract sales. Many foreign entrants proposed to develop a professional, college-educated, U.S.-type financial planner sales force in contrast to the traditional force. In addition, licensing with more than one company has not been permitted, nor is brokerage permitted except in very limited circumstances. Only life companies are permitted to be members of the LIAJ; therefore, as new products are being studied, outsiders, such as potential new entrants, have not been permitted to be members of the LIAJ and, therefore, could not directly assist in or influence developments.

Other decisions needing to be made include the form of entry into Japan with joint ventures having been once considered to be most preferable by the Ministry of Finance, but now wholly-owned companies are favored. And another decision that needs to be made is whether to use expatriate management with its attendant costs and other issues or to use local management. The most important element of corporate strategy in Japan, however, I believe, is staying power as well as patience since turning a profit on invested capital requires many years of patience.

MR. DAVID GULLAND: I intend to start off by examining some of the pan-European factors which are affecting product design across Europe. By Europe I mean the European Community (EC). I could talk to you on eastern European countries as well, but so far, and not surprisingly perhaps, we haven't really seen many new ideas coming out of that part of the world. After covering the pan-European pressures, I want to describe a couple of specific developments within the U.K., and then turn to what's going on in other countries in the EC.

So the first factor affecting product design in the EC that I want to talk about is the set of Life Directives that was passed by the European Council. In particular, the most recent of these, the Third Life Directive, was passed in November 1992. There are two key aspects of the Third Life Directive; first is the home control aspect. This means that a U.K. company, for example, if it sets up corporations in any other country within the EC, will be controlled by the home (i.e., the U.K.) regulator, not the regulators in the host country. That's a very important idea for product innovation.

The second important aspect of the Third Life Directive is the abolition of the ability of local regulators to have prior approval of new products. Currently, in many countries such as Germany and Italy, a company has to receive approval before it can actually start selling a product, and, as Marc was saying about Japan, this can really inhibit new ideas. Under the Third Life Directive, companies operating from a regulatory regime that permits rapid product development, such as the Netherlands and the U.K., should be able to introduce new ideas into these countries, which have been traditionally slower to accept new ideas such as Germany or Italy. So, in my opinion, the Third Life Directive should mean that there's going to be growth in product design work in the countries that are currently more closed.

A second Pan-European factor affecting product design is the increasing role played by the banks in the distribution areas. The banks have been a major source of change, particularly with their requests for special over-the-counter products that they can sell in their bank branches. Another area of distribution that is affecting product design is the sort of two-way process with the brokers. When product design becomes varied enough in a given country, brokers can start operating, and as the brokers start operating they in turn put more pressure on companies to provide them with new ideas. We've also seen developments such as pan-European television and teletext which is enabling people to market on a European basis.

We're also seeing companies starting to have differential pricing by different distribution channels. This practice is currently illegal in the U.K., but people try to get around it. In some countries such as Italy where it's also de facto illegal, new companies are actually being set up to sell through these new, more efficient distribution channels.

Two further factors, which in many ways are interlinked, are the general lack of capital in many countries in the EC and, also, the continuing recession. These two factors mean that new products have to be designed to be very capital efficient. But, also, the products must really match the general mood of the consumer in Europe which has tended to be, for the last year or so, fairly risk adverse. The difficulties experienced this past fall with the European Monetary Systems' Exchange Rate Mechanism doesn't really encourage people to put money in more speculative-type investments.

The final Pan-European factor, which Marc touched on before with respect to Japan, is the fact of the aging population. Only Ireland is not faced with this problem. Not only have we got an aging population, but a double whammy of the continuing recession. So the two pressures mean that governments are having to address how to reform the social security schemes, both with respect to pension provisions as well as health care.

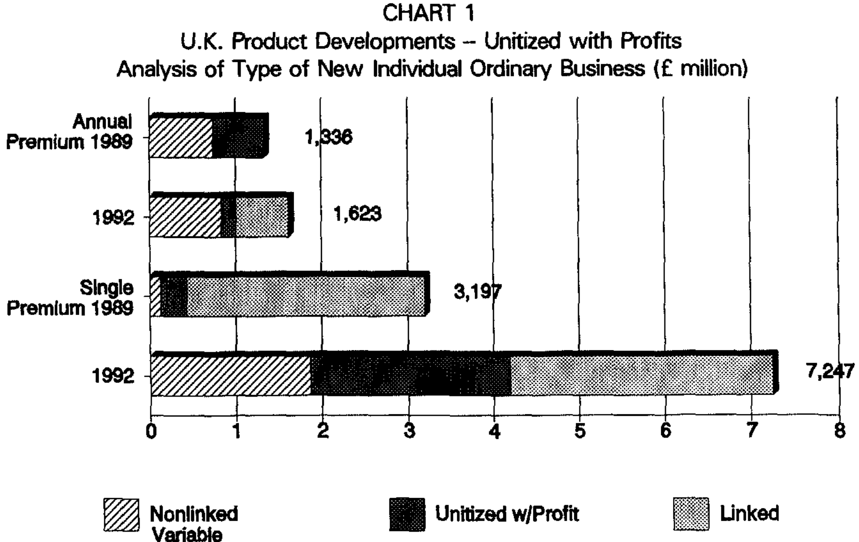
Of course, Europe is a very complex continent and we mustn't make the mistake that some people do by viewing it as a homogeneous mass. National market practices are crucial to effective product design and your decisions must be based on those. One example of this is the role technology can play in distribution. One company in Holland has been very successful in using teletext on T.V.s to market simple and complex products, life and P&C insurance, to consumers. Now that may work in Holland where you've got a very financially aware, astute, and educated population. The idea of using teletext and marketing through other countries is probably not as good an idea.

Having skimmed through my personal view of the pan-European factors, I'd like to dwell a little bit on a couple of product innovations that are going on in the U.K. I hope they're interesting to you but I don't think they're currently being sold widely in the U.S.

The first product I'd like to talk about is what we call "Unitized With Profits." Those of you who have some experience with the U.K. will be familiar with the word *unit-linked*, which I think translates to variable, and the words *with profits*, which translates to participating. This contract is both. I'm going to use the shorthand UWP.

This contract is new. It started in the mid-1980s. In fact, the first serious paper fully examining this subject was presented to the Institute of Actuaries about a week ago, so it's still a very new idea. Now before considering the contract in detail, Chart 1 will illustrate just how important UWP is to the U.K. market.

CHART 1
U.K. Product Developments -- Unitized with Profits
Analysis of Type of New Individual Ordinary Business (£ million)



Single-premium UWP business has dramatically increased from 1989 to 1992. The success with regular premium business hasn't been so dramatic to date.

So what is UWP? UWP is not a traditional U.K. with-profits contract where, for example, an endowment is sold on a very conservative basis and the actuary seeks to return the surplus emerging through complex structures of reversionary bonuses, which once added cannot be removed, and terminal or exit bonuses, which are added when the policy reaches maturity or there is a death. Nor is UWP a straightforward unit-linked (or variable) contract under which the policy value varies directly with the value of the underlying assets. It does, however, share features of both these contracts. Like a variable contract, the premiums purchase units in a separate fund of the life company. These premiums are completely flexible; they can be varied as to frequency of payment, and/or varied as to the amount of the payment. The risk benefits purchased under these contracts are generally bought by cancelling units. Both these aspects are like a variable contract. Unlike a variable contract the unit price can have guaranteed increases.

A recent survey by the Institute of Actuaries showed that two-thirds of the offices offering UWP guarantee at least 3% per annum increase in unit price, not at all like variable contract. Then, at the end of each year, the life company will declare a bonus either as an additional increase in the price of the units or as an additional number of units. This bonus is either given retrospectively for the last year or prospectively.

In addition, the unit price is guaranteed not to fall. This is very unusual in variable contracts. The companies protect themselves against the problems of mass surrender when the value of the assets is below the value of the units, such as in times of stock market crash, by giving themselves the power to impose a market value adjustment. Now every company that has a UWP has put that stipulation in as part of the document, but as yet no one has actually used it. They've generally been scared to be the first ones in the market to actually admit they need to do it -- sort of an example of the marketing man overruling the actuary. Some companies also have given themselves the power to impose this adjustment on the units purchased within about five years prior to maturity as an extra element of protection.

So that's a brief overview of UWP. It's still in the infancy and there's a wide variety of product designs being sold in the market to some extent reflecting each company's background, in particular whether it has traditionally been a unit-linked or a with-profits office. But either way, in a nutshell, companies are trying to convince the marketplace that UWP does offer the best of both worlds.

It offers the flexibility and the transparency of a unit-linked contract with the underlying guarantees of a with-profits contract. The main success of these contracts has so far been in single-premium business as Chart 1 showed. Now this money has tended to be a shift from deposit accounts into life companies and it's unclear how long that shift can continue. It's probably drying up already. Consumers have been dazzled by life companies' projections saying we're going to invest 50% in equity so you have all the benefits of that investment strategy, plus we'll have a guarantee of 3% and consumers have, not surprisingly, been attracted by it.

Another area where there is perhaps a more stable future for the contract is in personal pension plans, in particular, the regular premium versions. The mutual companies in the U.K. are very short of capital and selling large volumes with profits, regular premium business, is very capital intensive. The design of UWP means that you can sell more business with less capital.

Now there are two areas of concern among the actuarial world about UWP. It's grown so rapidly that some of the actuarial principles haven't really been discussed indepth. As I mentioned, the first serious paper on this subject was presented very recently. In particular, it's not clear whether the life companies that do have a 3% guaranteed increase built into their contracts are actually reserving for that guarantee, and if so, how? A second element of concern is the need by companies to control the volume of single-premium business being sold. In the EC our solvency margin is, in a nutshell, 4% of assets over liabilities. And it's quite clear that companies will have to limit the amount they sell, otherwise, their solvency position will be threatened. People actually turn that into a positive marketing approach by saying this contract is so great we can only sell 200 million pounds of it.

I'd like to discuss a second innovation within the U.K. – the introduction and apparent success of critical illness or dread disease policies. Now these are somewhat different from your accelerated death benefits policies. Under our critical illness contract, we tend to pay the full sum assured on the diagnosis of a specified list of illnesses such as cancer, stroke, heart attack, or major organ transplants. Now these don't have to be life threatening, which I think is the case in the U.S., and they can include deafness and blindness. Now they were introduced in the mid-1980s, first, as one more benefit in a universal life package, mainly sold by two dynamic companies with large direct sales forces: Allied Dunbar and Abbey Life. They were very successful indeed.

But since then we've seen them attached to endowments used to repay mortgages -- this is where they have become extremely popular. One bank estimates about 80% of its new endowments backing mortgages include critical illness as a rider. It's quite clear why: because it does meet a customer need. When you take out a mortgage, you want to be assured that it can be repaid if your earning power is reduced, so you have your disability income benefit, your life coverage, and now, your critical illness coverage.

Now that is becoming more popular in the market, and a few players are already selling it as a stand-alone contract. The leader in this market is a company called Pegasus. Pegasus is actually taking it one step further from the stand-alone product and packaging it with other health policies, such as major medical and disability income.

In the early years of its development it was criticized by many people because of the wide variety of definitions that different insurance companies were using to describe similar things such as cancer or stroke. So the major insurance companies and the major brokers got together late last year and early this year and thrashed out a standard set of definitions, which people are starting to use. But what companies haven't been doing is standardizing the illnesses covered. As new players come into

the marketplace, they've been trying to compete by this expanding list of illnesses covered.

Distribution aspects of the critical illness policy, the need for very detailed underwriting with a high rate of declinations or special conditions being imposed, coupled with tough claims control, with a high proportion of claims being refused, meant that at first it was really a product that could be sold only by a direct sales force. But slowly, as the product is starting to get more accepted and as the definitions have been getting sorted out and more standardized, the brokers are losing some of their initial mistrust and are starting to sell a little more of the business. But they're still a minor player in the market. As of 1991, roughly 15% of new policies were sold by either independent financial advisors or brokers, compared to 65% for direct sales forces with another 20% sold by appointed representatives.

There are obviously many other types of product development going on in the U.K. Some areas are: money purchase pensions, credit insurance, risk products (medex), and guaranteed equity products.

For various regulatory reasons, employers are moving away from defined-benefit schemes to defined-contribution schemes. At the same time, the government is, in effect, bribing people to "contract out" of the state pension. Instead, they are taking out their own personal private money purchase plans with insurance companies. This has required the insurance companies to come up with flexible, attractive policies for personal retirement in order to deal with the demand. The designs are not very new in terms of the concepts involved, being mainly unit-linked or with-profit contracts, but the flexibility is important.

Credit insurance is linked to the power of the banks in distributing products. In the past, when you took out a loan in the U.K., you had to be very careful not to take out a life policy by mistake. You had to tick a box that said, "No, I do not want a life policy to cover my loan" -- inertia selling. These practices have recently been outlawed, and it will be interesting to see the effect on the volume of new business. I should say that in Germany, from what I understand, banks still insist on creditor coverage. In Germany you can't have a loan without having a life policy backing it, which is quite nice for the German insurers.

Risk products are being motivated and driven in part by the extremely competitive environment in the U.K. savings industry. On the investment side, the U.K. insurance companies are facing increased competition from new products called personal equity plans (PEPs), and tax-exempt saving certificate accounts (TESCAs), which generally have a better tax treatment than your average life policy. So the U.K. insurers are turning to risk products such as critical illness and packaged life and health products to maintain their volume of sales at reasonable levels.

There has been growth in guaranteed equity products in the U.K. in the last 18 months. Legal and General was the first insurance company to offer one. These products guarantee that they'll give you back at least your initial premium or else the return on the stock exchange index. The companies generally don't mention that return excludes dividend reinvestment, so there is a nice margin for the company.

Turning to developments in the EC, I should stress that you can't treat the continent as one homogeneous mass, and my comments are really about traditional countries rather than Holland, which is in many ways very similar to the U.K. So there are some broad generalizations coming through here.

Currently, it would be true to say that product innovation is being restricted by the system of prior approval required in many countries. It also has been restricted by the very generous social security systems available, and it's being restricted by the limited range in the variety of investments that are available. All of this has limited both product supply and product demand. As a result, in many countries such as Germany, Denmark, Belgium, France, Spain, and Italy, the traditional revalutable policies have really ruled the roost. I'll come back to the revalutable policies in a minute, but as the forces controlling supply and demand change, we are already seeing new products designed just for the banks; we are seeing products being designed to replace benefits that are being cut out of the state social security systems. However, it is important to look at revalutable policies because although they're not particularly new, the concept is interesting and one that we must understand to see where Europe is going from them. So the traditional revalutable policy is either a long-term endowment or a long-term deferred annuity with a very cautious premium basis using low interest rates, population mortality, and heavy expenses. In addition, the contracts either share in all sources of surplus or just share in the interest surplus.

Initially, they only shared in the interest surplus; however, in Germany, they tended to share in all sources. This surplus is distributed every year either as single premium, which purchases additional benefit on the underlying premium scale, or else it ratios off the annual premium and the sum assured in line. That's where the word revalued comes from as the whole policy revalues upwards.

These contracts were very suitable for distribution through the tied agency network; there were nice heavy expense margins to pay commissions, long-term regular visits by the agent, etc. And in many ways they're comparable with the with-profit business in the U.K., but without the terminal bonus element -- which reflects the different types of assets backing the two policies. In the U.K., with the heavy equity backing, you need a terminal bonus element.

Back to new developments -- in the late 1980s banks, in particular, in France and also in Italy, were a major force for change. What the banks wanted in France were simple saving contracts, roughly equivalent to time deposits, which had to be designed to use the tax advantages of life insurance, both from the side of premium payments, premium relief, and with respect to the taxation of policy proceeds. They're generally shorter term than the revalutable policies -- seven or eight years in France, five to ten years in Italy. These products are being designed with very low expense margins which are designed to reflect the perceived efficiency of mass distribution through bank networks. These contracts also have high guaranteed surrender values, which are demanded by the consumers and reflect the deposit nature of the contract. These contracts have a very minimal mortality element. You often see them described as capitalization policies. In France they haven't been sold in such large volumes in the last couple of years mainly because of cannibalization problems. Banks suddenly realized that these contracts didn't have very high profit

margins and that the money coming in wasn't new savings from the public. It was instead funds being transferred from one side of the bank to the other side of the bank.

It is interesting to compare the continental developments in bancassurance described above with that in the U.K. In the U.K. there was a paper recently presented to the Staple Inn Actuarial Society that studied the whole issue of bancassurance from the U.K. perspective. In the U.K., the emphasis has been on using the bank's or building society's client base as a pool of warm leads on which to unleash newly created direct sales forces, selling the normal range of U.K. product.

The Bancassurance experience of France is also very different from that in Germany, which is protection oriented. Deutsche Bank's life company has as its major product simple protection policies not only backing loans, but also, genuine term insurance sold at lower premium levels than can be done through the very inefficient agency structure.

But it's not only banks that are driving new product development on the continent. We are seeing unit-linked contracts being offered now. This is a direct result of the pressures of the Third Life Directive. In Belgium, for example, from the start of this year, there has been a royal decree, which for the first time allows sales of unit-linked business. This has come about because the Belgium controllers and companies were worried that they wouldn't be able to compete once the Third Life Directive was in place because foreigners could come in with a wider range of products than they could offer. It's not clear whether people will actually buy this contract. In Belgium there are some tax problems with it, and the general risk adversity of the European consumer in general might mean that its product is not going to be the success that the U.K. actuarial professional thought it would be about two or three years ago. We were all saying, "Sell unit-linked contracts," and now we're rethinking that idea.

With respect to retirement provisions, we will see more flexible contracts such as those offered in the Netherlands, Denmark, and the U.K. We're starting to see these types of contracts introduced in Italy, Spain and Germany to a limited extent. And as Social Security Systems are cut back, we're starting to see a growth in major medical expenditures and health products as well.

Now that's been a very rapid tour of what's going on in Europe. In summary, I'd really suggest that we are going to see more innovation due to the Third Life Directive, and this should lead to more similarities across countries, but local market factors such as distribution issues and culture as well as the types of alternatives that are available for other savings vehicles will mean that country differences will be here to stay.

MS. CRANE: Now I'd like you to turn your attention to Central and South America. First, let me set the stage with a little bit of background information. David said that you really can't think of Europe as a homogeneous mass. You also really can't think of Central and South America as one homogeneous area. There are many different countries, and each has its own unique situation which can affect the products and the marketplace. It's really quite diverse.

But there is a second, broader distinction that needs to be made whenever you're talking about Central and South America and that's the difference between onshore and offshore insurance.

By onshore we're talking about the domestic companies and subsidiaries of foreign corporations that are legally licensed and admitted to do business in that particular country. They are generally selling products in the local currency, though there are some exceptions: Panama, Ecuador, and Argentina will allow you to sell products in U.S. dollar denominations. These are the companies that are licensed and regulated by the domestic insurance market.

By offshore we're talking basically of nonlicensed companies operating within that company. These companies are not admitted. They're not being regulated by the domestic insurance market. The products are sold in dollar denominations, U.S. dollars. Those of you who are familiar with this type of operator know it is often referred to as "bootleg insurance."

I want to explore some of the factors behind the development of this offshore "bootleg" market, which is generally strong in Central and South America, so we can understand the forces that have caused it to come into being. There might be various reasons why a foreign company may not want to set up a subsidiary in a particular country.

First, let's discuss regulatory obstacles. There may be restrictions, such as in Mexico, where the amount of foreign ownership of a particular corporation is limited to 49%. Many foreign companies might not want to set up and invest in a subsidiary in a particular country where they don't really have control of that subsidiary.

In some of the other Central and South American countries, the regulatory obstacles to become admitted are viewed by many foreign corporations as too onerous, too complex to fulfill. In fact, such regulations are often in the nature of a protectionist policy towards the domestic insurers.

In many of these countries, there are restrictions on the movement or conversion of the local currency, and foreign corporations may not want to take the risks involved in dealing in local currencies. There is, however, a trend towards opening up the marketplaces by removing some of the regulatory obstacles.

But by far it's the inflation and/or the economic instability that has plagued many of the Central and South American countries that really is the driving force behind the creation of the "bootleg" market. For example, in Mexico, from 1982 to 1987, the annual rate of inflation ranged from a low of just under 60% to a high of a 160% a year. If you go down to Argentina at the opposite end of the geographic region, realize that it has recently stabilized its economy and for the year ending June 1992, it had a 20% inflation rate. Now I realize by U.S. standards this would be a very high rate of inflation, but for Argentina, this is great progress. Twenty percent would have been a common or even a low rate for one month's inflation prior to that time.

Many of these countries experience frequent periods of hyperinflation unlike any we have experienced in the U.S. In the economies that suffer periodic bouts of

hyperinflation there is a natural hesitancy to make long-term financial commitments. One of the last things you want to be doing in a hyperinflated economy is holding cash or cash equivalents.

So I would make the case that one of the prerequisites for a domestic life insurance market to be viable is a stable currency, a stable economy not being plagued by hyperinflation. Conversely, because many of the South and Central American countries have been experiencing repetitive bouts of instability there hasn't been a lot of strength or interest in domestic insurance companies. As a result, especially for savings elements, they've turned abroad, towards U.S.-dollar-based products that can offer them more security and more stability. And even though we have and sometimes still do suffer from inflation, when viewed from the Central and South American perspective, the U.S. looks as constant and steady as a rock.

First, let's take a look at what type of offshore products are being offered. The products that are generally being sold are universal-life-type products, and they're fairly similar to those that we would see currently in the U.S. They are dollar-denominated products with premiums collected in U.S. dollars, benefits paid in U.S. dollars. They are very much investment-oriented products, funded at more or less a permanent insurance level.

One of the reasons that universal-life-type products are so popular in Central and South America is because of the explicit credited interest rate. The people are used to some rather volatile interest rate environment and a traditional product with a conservative fixed interest rate underlying its premium basis is not really acceptable. The universal life product design, on the other hand, is appreciated for its ability to reflect varying economic situations through the credited interest rate. Another important feature in this market is the premium flexibility offered by universal life product as opposed to an interest-sensitive whole-life design. These premiums are paid in "hard" currency, i.e., U.S. dollars, and the insured may not always have access to such "hard" currency. To have some flexibility over the timing and amount of their payments is seen as a plus. In summary, the flexible universal life product design is well received in the offshore marketplace.

As I said, most of the universal life products sold in Central and South America are funded at the permanent insurance level. This is due in part to the problems associated with selling term insurance through an offshore "bootleg" operation. One of the problems is the difficulties with financial underwriting. In the Central and South American countries people tend to be a lot more reticent to give financial information than their U.S. counterparts. They may not be as candid with an insurance company and/or with the government about their true wealth and/or income. As a result, effective financial underwriting becomes difficult (or in some cases impossible). In addition, the overall underwriting process is generally more difficult. You don't have Medical Information Bureaus (MIBs), Equifax is not sitting there ready to do an inspection report. You don't have access to laboratories that are specializing in insurance testing workups and attempting to send samples back to the U.S. to be processed creates logistical nightmares.

On the health insurance side, however, one company has come up with a rather innovative product that's being sold in this offshore market. It's a health insurance

policy with scheduled benefits, benefits payable in U.S. dollars. It has a very high deductible, and it is designed to be purchased by people who may want to have their medical treatment in the U.S. The high deductible reflects the fact that insureds aren't going to take such extreme measures as traveling to the U.S. for medical treatment for relatively minor illnesses. It's only for very serious illnesses that they really want these benefits. This particular company, in packaging this particular policy, started to set up preferred provider organizations (PPOs) in the U.S. in some of the southern entry point cities like New Orleans, Houston, and San Diego. Though Miami might be thought to be an ideal location, vis-à-vis, South America, the high cost of hospitalization and the high demand for hospital resources makes it difficult to negotiate reasonable PPO concessions from the hospitals and the doctors. This product is one of the more innovative in the "bootleg" insurance marketplace, providing a very different type of benefit other than savings and security of capital.

Now turning toward the onshore market, it would be impossible for me to cover all the countries. There are just too many differences with what's going on in various countries of Central and South America, but I want to turn to Argentina because I think it provides an interesting perspective on the current experience of the region. In Argentina there is a very substantial offshore "bootleg" market in operation. A number of carriers are selling down there quite successfully.

In the past, Argentina has suffered both hyperinflation and economic instability. But recently, there has been a move by the government, a very serious move by the government, to get its economy under control and in April 1991, the government passed the law of convertibility, which gives free conversion of the local pesos into U.S. dollars. And in November 1992, the government granted individuals the right to open U.S. dollar accounts and permitted banks to satisfy the Central Bank reserve requirements in either pesos or in U.S. dollars. Argentina has basically started to tie their currency to the more stable U.S. dollar. The government has really demonstrated a commitment to establishing stability in their financial markets and, as a result, we are seeing growth in these markets. These stable economic conditions have promoted growth in the life, health, and pension business. Confirming this fact, the Argentina life insurance premium historically represented only 5% of the total insurance premiums in the country. However, most recently, as of September 1992, 15% of all premium is life premium.

So, in Argentina, there has been an opening of the currency marketplace, a stabilization of the economy and, at the same time, Argentina has taken steps, in their regulatory environment, to encourage foreign investment. Argentina has encouraged foreign entry by allowing freedom of capital movement and capital investment, and opening up the use of foreign reinsurance. Argentina is actively encouraging companies to come into the domestic market; in fact, one of the major companies with a "bootleg" operation in Argentina is moving onshore. We can probably expect that in the future there's going to be less toleration of the offshore "bootleg" market as the country tries to increase its domestic life market.

Another factor that's affecting Argentina's domestic insurance market is social security reform. It has a proposed social security reform that would significantly privatize the pension, health, and welfare benefits. It's creating special pension fund administrators, called AFJPs. It has mandatory employer contributions up to 11% of

computable income with the amount of computable income capped at some point. At retirement each individual can elect to take an immediate annuity from the retirement insurance company or to have periodic payments paid from the AFJP. It's estimated that if enacted the AFJPs will have almost $3 billion of assets under management by the end of the first year and they're expecting by the end of the 10th year there would be $40 billion of assets under management.

Another aspect of the social security reform is that death and disability coverage may also be provided through the AFJPs by the pension administrator making a contract with a life-only company. It's kind of interesting because at present there are no life-only companies in Argentina. Most of the companies are multi-line companies and life is a sideline. But the social security reform is really providing the stimulus for the creation of life-only companies to service this marketplace. They're expecting the size of their group life market to double almost instantaneously if the social security reform is enacted.

There's also the potential under the social security reform for a new marketplace for supplemental coverages because, as I said, there are maximum contributions to AFJP similar to our social security system. The people with higher incomes will be looking for supplemental coverages tailored to fit within this system.

The product types in the onshore Argentinean marketplace are basically universal life and interest-sensitive whole life. The premium flexibility associated with universal life is not necessarily as important as it is in some of the "bootleg" markets because in Argentina they do have free access conversion to U.S. dollars. In fact, most of these onshore products are actually being sold in dollar denominations rather than the local currency. Similar to the U.S., there would be a minimum interest guarantee of 4%, and the payment of excess interest would be guaranteed by the contract generally phrased as a percentage of the investment yield, typically 80%, i.e., the company will pay you 4% interest or 80% of its investment yield if that's greater. Guaranteeing the formula for excess interest may be seen as somewhat limiting, but realize that there isn't a clear definition of the "investment yield." There's a lot of company discretion in calculating it; there is the potential for deducting investment expenses, etc., before coming up with this investment yield. At the same time, many companies will actually pay a higher percentage of this yield than is guaranteed by the policy. Some companies have paid 90% and a few have actually paid 100% for "good will" purposes. However, the company does have a great deal of discretion in the actual calculation of the investment yield that goes into that formula. So 100% might not really be 100%.

Most of the products are back-end loaded with hefty surrender charges. The surrender charges typically grade off by about the 15th year, a little bit longer than most U.S. universal life contracts, but it's not really an excessive period of time.

Another product that's rather popular in Argentina is deferred annuities. They're similar to deferred annuities sold in the U.S. They have similar minimum interest guarantees generally not in excess of 4% and, again, they guarantee their excess interest formula. However, with deferred annuities, the formula is generally the investment yield less a management commission which is somewhere around 40 basis points. But, again, the companies have some discretion as to how they

calculate the investment yield. One interesting aspect of this marketplace is that deferred and immediate annuities are only sold by a certain type of company. As I said previously, there are no life-only companies, but they do have a special type of company called a retirement insurance company. Annuities are sold only through retirement insurance companies. In fact, a retirement insurance company basically can't sell anything but annuities. Retirement insurance companies are allowed to sell life coverages but only as riders to annuities. These retirement insurance companies are much more heavily regulated than general insurance companies. There's a real discrepancy between the amount of government regulation that these specialized annuity companies are subject to versus general insurance companies.

Other types of products being sold in Argentina consist of some YRT and some five-year term. There is a moderate amount of group insurance being sold, both death and disability, and some credit insurance.

Recently, children's riders are being to be added to life policies. They're usually expressed as some percentage of the base policy, such as 10%, 20%, or 30%. The child's rider is usually an endowment-at-18 type product so that the child's rider will actually endow for 10% of the face amount "to fund college expenses." There are some dread disease coverages being sold, but they are fairly limited. The companies don't have access to a good statistical basis and therefore are proceeding fairly cautiously. The coverage is generally limited to stroke, heart attack, or cancer.

There is basically no major medical or long-term care being sold in Argentina.

Now let's switch back for a moment to the offshore market. It's very active in Argentina with all the companies involved selling about 2,000 policies per month; again, the products are universal life products targeting wealthy, high-income individuals who are fairly knowledgeable about investments. These are really investment-type products.

Chile is fairly similar to Argentina only it has had a more extended period of economic stability. Their economy has been under control for a longer period of time. There still is a fairly vital offshore "bootleg" market being operated. Onshore, the companies are primarily selling death protection. One of the interesting things that we're seeing here is that it's being sold in what is called U.F. monetary units; U.F. stands for Unidad de Fomento the exact translation of which I really can't provide. Anyway, this monetary unit is indexed and it is revalued daily. Both premiums and death benefits are payable in units. So, if a policy's premium is 10 units, on the day you pay your premium you look up the value of a unit, multiply by 10 and that is how many pesos are needed to pay your premium. When an insured dies, the beneficiary will be paid 1,000 units, valued at whatever a unit is worth in terms of pesos. So it's a kind of an internal indexing of the policy. This is in contrast to Argentina where indexed policies are not allowed. In one country, all policies are being sold in U.F. monetary units, which creates automatic indexing, and in another country they don't allow any type of indexed products.

Chile has already had a significant privatization of the health, welfare, and pension system similar to that being proposed in Argentina. There's a fairly active market

growing to supplement these coverages. These supplemental products are being developed for the higher income individual.

I'm winding up here and so far I have covered two countries, Argentina and Chile, that have a fairly actively growing domestic life market. Mexico is another country with a growing domestic life insurance market. In Mexico, like much of the Central and South American region, the main product is universal life, but it's a little bit different. In Mexico we tend to see heavily front-end-loaded products with an option B type death benefit. That's the style of universal life that's currently being sold in Mexico. Besides universal life, another product that's currently popular in Mexico is term insurance with scheduled cost-of-living increases.

The Mexican government has passed various regulations and laws that have acted as a stimulus to the domestic insurance market; in fact, in March 1992 it passed a law that allowed for the tax deferral of the inside buildup on annuities. Prior to this, deferred annuities were not very popular because they really weren't tax efficient within the Mexican framework. Now, somewhat like the U.S., they have sheltered the inside buildup and we're seeing, of course, an expansion of that marketplace.

Also in Mexico there is some privatization of the pension system, the SAR, which is a savings system for retirement. The SAR is similar to the other pension scheme we've discussed based on a very simplified formula: x percent of salary. In 1992, the employer was the controlling party determining where these funds would be invested and only banks were licensed to deal with these funds. In 1993, employees will now have the option to direct their particular fund. In addition, they have expanded the entities that may handle these funds and now licenses have been extended to insurance companies, stock brokerage houses, and other financial institutions. These changes have created immediate opportunities for the domestic insurers in the Mexican marketplace.

One last comment as we focus on Mexico is the North American Free Trade Agreement (NAFTA) which, if it actually goes into effect, could cause some significant changes to the Mexican domestic marketplace. Probably one of the more immediate changes would be the lifting of the limitation on foreign ownership, currently limited to 49%, which might make Mexican subsidiaries of U.S. companies a more viable alternative and a more desirable investment.

MR. WILLIAM E. NEFF, III*: I have a question about group life in Mexico. There's a proliferation of U.S. industry going into Mexico and, of course, a lot of it is because the cost of doing business there is much less. What do we see about the use of group benefits, specifically group life and AD&D in Mexico as compared to what you've seen here?

MS. CRANE: Well, I'd have to admit that I am not very familiar with the group side of the Mexican marketplace. Perhaps Jeff Harper, who happens to be in the room, might be able to shed some light on that issue.

* Mr. Neff, not a member of the sponsoring organizations, is Director, Group Reinsurance at Cigna Re in Hartford, Connecticut.

MR. JEFFREY C. HARPER: The group insurance marketplace in Mexico is about a billion dollars worth of annualized premium and it's all-risk-type premium. There isn't much permanent insurance sold on a group basis. That's about the same amount of premium as ordinary, so it's about half and half between individual ordinary and group insurance. Group insurance is subdivided between the large groups and small groups. One of them is bigger groups and there's less underwriting; that's the type of group you're used to in the U.S. And the second type of group is for smaller groups, say under 15 or under 25, I forget the exact number and there you do have a few of the group permanent type coverages. There's a three-minute rundown of everything I know.

MR. PAUL E. BUELL: What is the marketing mechanism for the offshore market from those South American countries, and what is the attitude of the regulators in that situation? You mentioned at least tolerance I guess, but are the companies doing business there technically illegal, for example?

MS. CRANE: Yes, in general they're technically illegal. I wouldn't know the exact status in each country, but for the most part, this is an illegal "bootleg" operation.

There tends to be a fair amount of toleration by a number of countries, realizing that the hyperinflation and general economic instability that they have been experiencing really jeopardize the value of people's assets when they're held in the domestic financial markets. These policies are basically sold and marketed through agents that are in those countries. I think as some of these countries finally stabilize and start to build and grow a domestic insurance market, there probably will be less toleration, but at present, in many countries, I think they see the offshore market as almost a necessary alternative. It's people at the much higher socioeconomic end of the scale who are utilizing these offshore markets and these are probably people who also have influence, thereby, increasing the toleration level.

FROM THE FLOOR: How do we know the size of the market you mentioned? Is it about 2,000 policies being sold in Argentina each month?

MS. CRANE: Yes, that was collected from a study done by Tillinghast's Buenos Aires office, which has been monitoring the offshore activities.

MR. WILLIAM D. KERRIGAN: I wonder if David could comment about the different distribution methods that are in use today in the U.K. and Europe (tied agents, brokers, bank distributions) and how you might see that changing in the future.

MR. GULLAND: Well, that would be a half an hour talk actually. Within the U.K. there are regulations, SFA 1986, which requires agents to either be tied to one insurance provider or else offer what's called best advice. It's an ambiguous statement in itself. As a result, in the last four or five years in the U.K., the individual brokers in the high street, the typical one-man band, have really lost a lot of the market share. They haven't been able to have the backup to prove to the authorities that they are capable of providing investment advice or the market research needed to go into that area. So they've turned away from being independent, to being tied to one company. Whether they actually were truly independent in the past is a moot

point and, practically speaking, most of them were tied to four or five companies. So that's on the individual life product.

The banks in the U.K., again, before the SFA 1986, the bank managers tended to have their own little agency and it would place life contracts here and there and everywhere and pocket the commission. Since the SFA, they have either become tied to one provider or else increasingly set up their own life companies: Barkley's Life, Blackhorse Life, and Midland Life. Nat West was the only one of the big four banks in the U.K. that didn't set up its own company. It went the independent route for a while offering best advice. But it has now started its own company, Nat West Life, and that's going to be one of the largest operations we've seen in the U.K. To get on with the U.K., the traditional mutuals in Scotland used to service these high-street brokers and they were really the factories, producers of life products. There was no control over distribution, and what they're now trying to do is sort out their own tied agency structures or else get into direct sales forces. So there's a lot of activity the last two or three years of people buying and selling direct sales forces as unities, which I think happened quite a lot in the U.S., but it was new to us.

Turning to distribution in a country like Germany, for example, you may be surprised that there's actually more regulation over frankfurter street vendors than there is over life insurance salesmen. There's no control over who can sell life insurance in Germany. Very surprising. Very unprofessional career in many ways. What people are trying to do now in Germany is establish a more professional approach to selling and people are starting to have direct sales forces. Equitable Life, our Equitable Life in the U.K., is now starting to operate in Germany and it's going to try to use the same method of sales forces as we use in the U.K. so that covers most of the issue.

FROM THE FLOOR: Most of it. Do you see the broker market continuing to go down and banks continuing to get a bigger share?

MR. GULLAND: In the U.K., yes, but in places like Germany, I would expect brokers are starting to become more important. Brokers are already placing business overseas in Germany. Quite a few U.K companies have sold quite a few, both term insurance and, also, saving contracts through brokers into Germany. And as the German market becomes more differentiated and products become more varied then the brokers will have a chance. It's like the chicken and egg. You can't be a broker before you can have something to offer. When all products are the same there's no role for a broker. The banks will be an increasing power in distribution in nearly all the countries for different reasons.

I will mention one thing about offshore products. There is a similar situation in countries such as Hungary and Czechoslovakia, as you are seeing in Latin America. In the German, Italian, and to a limited extent English companies, there actually was a bit of illegal activity in the past year or so, but the local authorities in Hungary have come down quite strongly against that. They're really trying to boost the actuarial profession in those nations to put the insurance industry in a sound footing.