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LIFE INSURANCE AND THE BUYER

by Anna Maria Rappaport

At the meeting of the Actuaries Club of New York on Oct. 5, there were two panel discussions; one on Consumerism and one on the Interest Adjusted Cost Method.

At those discussions, I heard a great deal about providing the consumer the means to make an intelligent choice. When intelligent choice is mentioned, it is often assumed to mean the ability to make meaningful price comparisons. Price comparisons are but a small part of the problem. Solving the price comparison problem does not make intelligent choice possible; substantial and difficult problems which are far more important must be solved first. If we assume that a better cost method is the solution to providing the consumer a way to make an intelligent choice, then we missed the major issues.

In this article, I will express some thoughts on the concept of intelligent choice and try to clarify the position of the buyer who wishes to make an intelligent choice with respect to various types of purchase decisions. The life insurance buyer has a very difficult time making an intelligent choice. The product is complex and confusing. The following factors must be considered in the rational selection of life insurance:

(1) Amount of coverage needed.

(2) Understanding of the basic workings of various products, and a rational evaluation of death benefit and savings priorities.

(3) Choice between various types of products.

(4) Choice between companies—based on different product features, cost and service.

(5) Choice between agents.

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ACTUARIAL EDUCATION

by Paul J. Brennan

"Actuarial Education" was the subject of a recent meeting of the Young Member Activity Committee of the New York Actuaries Club.

Robert Johansen, Chairman of the Education and Examination Committee, and Walter Miller, Chairman of the Continuing Education Committee, began the program by discussing their Committees' roles in the education of the actuary.

Mr. Johansen discussed the role of each examination in the total process of education and qualification of new Fellows, stressing the educational aspects of the examinations and explaining how the various subjects fitted into the definition of the "complete" actuary. He was careful to point out that post-Fellowship education and further training were required for full professional stature.

Discussion from the floor focused on whether or not the basic goals of the examinations are being achieved. Many of the younger members expressed the belief that the exams emphasize memorizing lists of trivia instead of developing problem-solving abilities. Since this was not the first occasion on which such opinions have been expressed, the participants at the meeting agreed that a workshop on the exam system should be scheduled for the 1972 annual meeting along the same lines as the session at the Denver meeting in 1970.

In the area of study materials, the E & E Committee would prefer greater use of textbooks and published papers for study materials, but due to the rapid changes in all fields of actuarial work, extensive study notes are needed to keep the material current. The big problem with study notes is, of course, getting people to prepare them. Society members who are recognized experts in

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SECTION 213

by Daniel J. Lyons

Changes have been proposed in Section 213 of the insurance law of New York on behalf of the American Life Convention, Life Insurance Association of America, and Association of New York State Life Insurance Companies. Generally speaking, the changes are required because of long continued inflation. The New York Insurance Department is at present considering the proposed changes.

Section 213 was revised in the early fifties to update it for the inflation of the previous 15 years. At that time substantial changes were made in the formulae for total expenses and total field expenses. It was recognized that continued inflation would require updating, but there did not appear to be any practical way to provide for this in advance.

We have now experienced another 15 years of inflation and the margins existing in 1955 have been seriously eroded —more, of course, for some companies than for others. The changes in the statute now proposed would, on the average, restore the margins relative to the proposed limits to the levels of 1955, both for total field expenses and for total company expenses. Actually the changes to accomplish this are quite simple consisting of an increase from $.50 to $.65 in line 36 of Schedule Q and an increase from $1.00 to $1.30 in line 37 of Schedule Q.

Another casualty of the inflation has been the small company allowance. This is a special allowance provided in the statute in recognition of the fact that small companies are likely to have great difficulty holding unit expense rates down to the level of the large companies. Accordingly additional sums computed by formula are included in the total field

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Pensions in Europe

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Germany

In Germany there are also many private pension plans, but most of the larger ones are financed through book reserves rather than funded through insurance or segregated pension funds. Appropriations to such book reserves are tax deductible, but only subject to their being determined according to an imposed inflexible government pattern, including a minimum interest assumption of 5.5% and a level formula for reserve accruals that precludes any recognition of "past service liability." The relative lack of employee security inherent in the book reserves, together with the rarity of vesting provisions, have generated considerable criticism recently, and the situation in Germany seems to be headed towards some fundamental changes.

Switzerland

In Switzerland there are also many occupational pension plans supplementing the rather modest social security pensions. Whether insured or self-invested, pension contributions are invariably channelled through a pension foundation (analogous to the pension trust in the United States and Canada) in order to meet the basic requirement for tax deductibility that the funds be non-recoverable under any circumstances. Pension contributions and reserves are generally based upon actuarial advice, but irrevocable contributions are generally tax deductible in full regardless of their relationship to the actuarial requirements.

France

In France the concept of actuarially determined reserves for pensions was so thoroughly discredited by the runaway inflations that followed the two World Wars that even today the "capitalization" of pensions obligations is virtually unknown. The widespread multi-employer pension systems that complement the basic social security pensions for a majority of French employees are financed through a sophisticated pay-as-you-go system known as "repartition." This has worked remarkably well for a 25-year period of rising earnings and expanding employment, but still has to meet the test of real adversity. Meanwhile the French are quite content in their belief that the next generation of workers is a more dependable source of old age security than is the franc.

Sweden

In Sweden a two-tier social security system is supplemented by third tier—a uniform, collectively bargained, privately financed system, at present for salaried employees only, but to be extended to the hourly paid workers in 1973. The third tier may be funded through direct insurance, or financed by book reserves, but in the latter instance must be "reinsured" by "pension guaranty insurance." If book reserves are used they must be accumulated according to exactly the same actuarial reserve pattern as is uniformly applied for pension insurance. This inflexibility, together with the homogeneity of the Swedish population and the business structure, makes the insurance possible. Nevertheless, the company issuing the pension guaranty insurance may refuse to issue it in the case of small or apparently unstable employers, in which case they have no choice but to insure their pension obligations directly.

Other Variations

The foregoing is merely a highlight summary designed to illustrate the wide diversity of pension financing concepts found in Europe. Other variations are found in other countries, except that in Spain and Italy the few occupational pension plans that are found are usually informal and unfunded. Sources of more detailed information include papers and discussions presented at the 18th International Congress of Actuaries, the Reference Manuals published by the International Benefits Information Service (IBIS) and the Kleiler report reviewed in the October issue. □

Life Insurance and Buyer

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The purchaser may be unable to make a rational choice for the following reasons.

Selection of a suitable amount of insurance is a part of long-term financial planning for contingencies. It is difficult for most people to do such planning.

The individual buyer does not really understand the use of the product, and has not defined the need which the insurance will meet. (The business insurance buyer is usually in a much better position because the need has been well defined and quantified). He does not understand what the various different products are, and how they can serve to meet differing needs. Until the buyer understands how the product works, attempts to compare price are essentially meaningless. Further, meaningful price comparisons are difficult to make, and the knowledge and information to make them are usually not available to the consumer.

Intelligent choice is possible only for those buyers who wish to make a rational choice, and who are willing to make the effort required to develop the necessary information. It is one of the functions of the consumer movement to exert pressure so information will be made available to analyze a purchase with a reasonable amount of effort. In my opinion, there are a number of conditions which must be present in order for the buyer to be able to choose rationally:

(1) The buyer must understand the use of the product to him. It is only possible to evaluate a product in terms of the use to be made of it. An individual buying an automobile must be able to understand the use he intends to make of it, or he will be unable to choose between a sport car, a stationwagon, or a sedan. The individual buying insurance must have clear priorities in terms of death benefits at various points in time, retirement needs, etc. Until needs are well defined, it is impossible to determine whether or not they have been met.

(2) Adequate usable information must be available about the product. This information may be provided either by an outside agency, or by the seller directly. However, information provided by the seller will normally be available only because economic or other pressure has forced the seller to provide it. This information includes disclosure of price, features, and all relevant data needed to compare the product with other products which might fill the same need.

(3) The buyer must feel that the purchase is of sufficient importance for him to be willing to make the effort to investigate. He must also recognize that differences exist in the product provided by various sellers and he must feel that it is possible for him to develop the information he needs.

Where does the buyer's information come from? The most direct and simple source of information is the buyer's own experience. This is probably very helpful when choosing clothing or when mak-

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Life Insurance and Buyer

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ing any type of purchase which is repeated relatively frequently. It is not very useful in making a large purchase of a type not made very often. Experience is also very useful to the specialist who is selecting on behalf of a business or other organization.

Other information comes from published sources; for example: *Consumer Reports,* or published lists in trade journals of all comparable equipment of a certain type on the market. This information is useful to the purchaser able to determine independently what he wants, and wishing to evaluate competing products on the market.

A third source of information is the seller. Such information is normally presented to promote the sale. A purchaser looking at a product about which he is knowledgeable will know what to ask for, and also will know how to interpret the information. A purchaser not knowledgeable will be influenced by the information, but it may not help him to make an intelligent choice.

An additional source of information often used by business and other organizations is the paid consultant. It has no relevance for the individual consumer.

What is the impact of the distribution system on the buyer and his ability to make an intelligent choice? The buyer has the best choice when he seeks out the seller, and when there are a number of retailers selling like products. In this situation, the need is established prior to contact with the seller, perhaps by the buyer's own life style or that of his neighbors, or by advertising. However, if the buyer is to make an intelligent choice, he probably will need either sufficient experience, or data from a third party source. Information provided by the seller will probably be of limited use, because this buyer has little economic power, and economic power is what forces the seller to provide more data.

The buyer also seeks out the seller when he is looking for professional or consultant services. The individual, in choosing, however, probably has little basis for comparison, and must rely on references. The provider of the service is the expert, and it is extremely difficult to choose intelligently whenever professional services are sought.

The buyer is in a most difficult position whenever he must deal with an expert salesman in an area in which the salesman is a specialist. Long attempts to collect information can lead to a large collection of unusable data. This is true whether one is buying a home heating system or life insurance.

The distribution system for life insurance has an additional feature which further complicates the problem. The salesman, at the point of sale, is creating interest in the product and convincing the purchaser that he needs it. The buyer, who is sold the need and the product, at the same time is likely to perceive the need vaguely and in the way desired by the salesman, and therefore he will often not be in a position to make an intelligent choice.

The life insurance distribution system creates another problem: the compensation paid to the agent for various products encourages the agent to present a picture that will favor permanent insurance. As long as agents receive a substantially higher commission for one product as compared to another, many of them will not present the facts about different products fairly.

What can be done to help the buyer of life insurance? The suggestions here of course involve a long term effort on the part of the industry, outside organizations, and regulatory bodies.

First, we can try to make available information which will enable the buyer to understand the product so that he will see what death benefits it has, what cash values it has, and what other features are present.

Second, information can be made available to help the buyer analyze his priorities, and decide what he needs.

Third, pattern of compensation to agents can be changed so that the interest of the agent is not adverse to the interest of the client. This would require in New York a revision of Section 213 of the Insurance Law so that the same commissions could be paid on term as are paid on permanent.

Fourth, information provided at time of sale could be expanded to disclose product choices, and to disclose costs on a better basis, either using the Interest Adjusted Cost Method, or a method such as one presented by Stan Hill in his recent paper. And in so doing, we must remember that illustrations of cost, either good or poor ones, are of no use to the buyer unless he understands what his dollar is buying.

In closing, I will raise a question: How can we encourage the life insurance industry to do an honest job of disclosure to our customers? Disclosure of price is important, and better price disclosure should be aimed for, but that is merely the tip of the iceberg. □

GREATLY EXAGGERATED

The report in the Society's circular letter of November 30 that we were losing the editorial services of Kenneth T. Clark was considerably premature. Mr. Clark has returned to Canada and will continue as one of the associate editors of *The Actuary* with added responsibility for commenting on Canadian affairs.

OPERATIONS RESEARCH

Guidelines for the Practice of Operations Research, *Operations Research,* Vol. 19, September 1971

by James C. Hickman

Actuaries have spent a lot of time in recent years struggling to define their professional role in conflict situations. The fascinating September, 1971, number of *Operations Research,* the scientific journal of the Operations Research Society of America (ORSA), should make it abundantly clear, if anyone remained in doubt, that actuaries are not alone in this struggle.

The very success of analytic methods in planning, managing, and evaluating complex systems has forced operations analysts, often without much previous experience, into the political arena. Exactly the same statement could be made with respect to actuaries by narrowing the definition of "complex systems" to those involving pensions and insurance. It seems to be a common contemporary experience for practitioners of a technical discipline, originally developed to manage a modest range of problems, to find their discipline applied to influence decisions with rather awesome global consequences.

For operations research, the moment of truth came in connection with the 1969 Congressional debate on the Safeguard anti-ballistic missile system. It is perfectly obvious that the outcome of this debate will continue to have a signi-

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