The Actuary

February 1979 – Volume 13, No. 2

The Actuary
The Newsletter of the Society of Actuaries
VOLUME 13, No. 2 FEBRUARY, 1979

PERMUTATIONS AND COMPUTATIONS

Life Insurance Marketing and Cost Disclosure. U.S. House Subcommittee Report on Oversight and Investigations, Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402 (Stock Number 052-070-047887).

by E. J. Moorhead

This is the first in a series of articles. The first three will be limited to highlights of the Moss Report. After that our columns will be open for discussions and suggestions of what actuaries, individually or collectively, might do about responding to the report's various recommendations.

Last year the House Subcommittee on Oversight and Investigations (a Congressional entity to which the Federal Trade Commission reports) decided to look into the effectiveness of state regulation of life insurance marketing practices—especially into the extent to which life insurance buyers are sold the products they need and are enabled to compare prices to their own advantage. As recently as ten years ago these marketing questions were not in the regulatory arena at even the state level, which shows that there is indeed a tide in the affairs of men.

Chairman John E. Moss (D.-Calif.) conducted hearings in August 1978, the organization of which was mainly in the hands of Subcommittee Counsel Jay C. Shaffer. This observer's impression is that Mr. Shaffer established a first class reputation for himself in his study of the subject, in his colloquies with testifiers, and, most of all, in the composition of the ensuing report that is the subject of this series.

The report consists of (i) 64 pages of main text arranged in three chapters; (ii) six pages of the dissenting views of Rep. James M. Collins (R.-Texas), who was formerly president of Fidelity Union Life Insurance Company; and (iii) 31 pages of appendices.

(Continued on page 4)

ANNOUNCING A CONTEST TO MARK OUR NINETIETH ANNIVERSARY!

The Actuarial Society of America came into existence at a meeting of its twenty-seven founders at the Astor House in New York City on April 25th, 1889. To mark our 90th birthday, *The Actuary* offers an exciting and potentially useful contest between the following important groups of Society members:

NEW FELLOWS, CLASS OF 1978
vs.
FORMER MEMBERS OF OUR BOARD OF GOVERNORS

The object is to determine which of these two groups can send in the largest number of the best quality of *mentions of any of the words, "actuary", "actuaries", "actuarial"*, found by them in the general press during our birthday week, *Sunday, April 22nd to Saturday, April 28th, inclusive.*

Such items, to qualify, must be in a Canadian or United States magazine or newspaper of general distribution, and clearly must not have been inserted by an actuary, an insurance company or association, an actuarial firm, or an employment agency.

Submissions must consist of the original or a copy of the article, and must identify the paper or magazine and its date of publication. In case of duplicate submissions, a modest effort will be made to ascertain which was sent in first.

Quality will be rated for contest purposes on a scale from one to five. High ratings will be for statements that indicate the writers' appreciation of what an actuary is and does.

Decisions of the Editor will be regarded, at least by him, as final. Submissions must be mailed no later than May 4, 1979, to: E. J. Moorhead, 2594 Woodberry Drive, Winston-Salem, NC 27106, U.S.A.

Winners, and the findings, will be announced in the May *Actuary*. □

DISPARATE ORIGINS OF LIFE AND NON-LIFE INSURANCES

A view by
Robert E. Beard, F.I.A., A.S.A.

Ed. Note: The Actuary believes our readers will find food for thought in Mr. Beard's succinct analysis, reprinted here with the author's permission from JIA 105 p. 107.

"The success of actuarial science with life assurance stems from the combination of the invention of the life table, and the recognition that this was an appropriate model on which to build, with a technical fault in the construction of of an early life table through which mortality rates were overestimated. This unsuspected margin built into the premiums resulted in the emergence of surplus, the distribution of which provided the key for operating an enterprise built on contracts under which the amounts were known but the time of payment was a random variable. In effect, the with-profit contract was a very happy device by which the insured provided his own risk capital. The main actuarial function was then to set premium rates high enough to provide a margin over the likely experience so that profit was not distributed before it was earned and so that trends in experience could be measured and reflected in management decisions.

"Non-life insurance evolved in a different way because the underlying risk process is different. Two main streams may be discerned. The first, and in market terms the smaller, may be described as simple or domestic risks. These are fairly numerous and comprise reasonably homogeneous groups, evolving historically from local mutual societies. In some respects the business resembled sickness insurance, the main difference being the frequency rate of claim and the dependence of benefit on value rath-

(Continued on page 8)

Permutations and Computations

(Continued from page 1)

Chapter I is entitled, The Term/Whole Life Choice. The sections of this chapter, with key quotations therefrom, are:

The Choice Presented. "The threshold question an insurance purchaser must address is whether to favor term or whole life as a way of satisfying his insurance needs. On this issue, the industry and its commentators are divided into two camps. (Here follows a description of the contrasting arguments, familiar to actuaries, of term and whole life advocates, after which there is the Subcommittee's view on these arguments).

Analysis of the Choice. "Insurance is designed to spread risk. In the case of life insurance, the risk is that of *premature* (emphasis in original) death. The concept of prematurity is important . . . Life insurance exists because people who generate income fear that death will occur before they will accumulate a fund sufficient to satisfy a prospective financial need. People who have no significant, prospective financial needs or who have accumulated wealth sufficient to satisfy any possible needs, do not require any life insurance at all.

Information Needed. "These features of insurance lead us to conclude that any person considering life insurance should compare (1) the funds that will be assured under a whole life policy with (2) the funds that will be assured by allocating available premium dollars between term insurance and a side investment fund. We reach this conclusion, because, if the difference between term rates and whole life premiums is large enough, and that difference can be invested at an attractive interest rate, the side fund investment may eventually accumulative to cover all of the policyholder's insurance needs. The term plus side fund alternative might then be a wiser choice than continuing to pay whole life premiums forever . . .

"This comparison, of course, will not in itself answer the question about which type of policy to favor. Later in this discussion, certain advantages unique to whole life policies and certain other factors will be discussed that, in our view, could well support a decision to purchase a whole life policy even if a higher fund accumulation could be achieved by purchasing term insurance.

"We are firmly convinced, however, that life insurance purchasers must confront and address the relative merits of whole life and term if they are to make reasoned purchase decisions . . .

Inadequate Market Information. "The problem we find in the market is that the methods used to sell life insurance do not ensure adequate and accurate understanding by consumers of the available product alternatives. This conclusion results mainly from our conviction that many life insurance agents have both strong financial incentives and abiding philosophical convictions that favor one insurance alternative over the other . . .

"We regard this situation as a formula for market failure. Insurance is a complex product, and many customers are no doubt content to follow whatever advice their agent offers . . . It is simply evident to us that agents who have philosophical and financial biases favoring one product alternative will inevitably tend to steer their sales prospects in the favored direction. We want to make clear that we are not ascribing any improper acts or unethical conduct to agents in promoting their views to their customers. We are simply determining that the natural operation of the ordinary life insurance marketing system is not very likely to foster the informed consumer choices necessary to produce the benefits of competition and maximize consumer welfare. It is clearly undesirable for a consumer's purchase decision to be determined by the views of whichever agent gets to him first . . .

"The most recent analysis of Linton Yields for individual whole life insurance policies appears in a 1974 Report by the Society of Actuaries." (There follows a pair of tables from the 1974 Munson Committee Report showing respectively mean and maximum Linton Yields).

Solutions. ". . . We now turn to our four recommendations for solving the problem by increasing the amount of unbiased information available in the marketplace.

"Recommendation 1: First, we recommend direct disclosure of information that will encourage and enable a prospective life insurance purchaser to compare whole life with a 'buy term and invest the difference' alternative."

(A method, given the name *Cash Accumulation Method,* is proposed for this purpose as an alternative to the Linton Yield Method, and is on the whole regarded as preferable to the latter. The Cash Accumulation Method differs from Linton Yield only in that a reasonable interest rate to be earned on the side investment fund is stipulated instead of being derived by computation. The Fund produced by the Cash Accumulation Method is to be used in each of two separate comparisons. One of these is with the whole life policy cash value at any policy duration in which the buyer may be interested; the other is with the whole life policy *face amount.* One purpose of this double comparison is to accommodate both the buyers who are interested in cash values and the buyers who are confident that they will maintain their policies in force until death. The Report contains this comment:

> "Very recently the FTC provided us with an analysis of 306 different $25,000 whole life insurance policies issued in 1973 to males aged 35. They compared those policies to an alternative program of term insurance plus a side fund accumulating at an after tax interest rate of five percent. They found that the mean attained age at which the side fund would 'cross over' the whole life *face amount* was 67.")

"Recommendation 2: Our second suggestion for correcting the market's failure to provide adequate information relevant to the term versus whole life choice is designed to deter early lapse of whole life policies. We recommend that any cash value table displayed for a whole life policy reveal clearly and conspicuously those policy years for which the cumulative Linton Yield is less than zero.

"Recommendation 3: . . . Our third recommendation . . . is to provide consumers with a Buyer's Guide.

"Recommendation 4: Our fourth recommendation is that the NAIC, the FTC, or both, should study how to encourage the development of professional insurance consultants who would provide counsel and advice to consumers for a set fee. Whenever consumers purchase products and services on the advice of salesmen whose compensation level depends on the amount expended by the consumer, some abuse is likely."

(TO BE CONTINUED)