The Actuary

September 1983 – Volume No. 17, Issue No. 7

REPLACEMENTS DISCUSSED AT CANADIAN INSTITUTE

by Michael B. McGuinness

At the Canadian Institute of Actuaries meeting in March 1983, a panel of Charles T. P. Galloway, Prof. Joseph M. Belth and Gerald A. Fryer addressed these questions:

> Can a policyholder reasonably expect to be advised by his company or his agent when to "select" against his company either by surrender and reissue or by replacement with another company? Do the policyholders of a mutual company have more "rights" in this respect? Are nonguaranteed cash value products capable of being sold? Can we explain to our agents or policyholders why asset values fluctuate when we compete against Canada Savings Bonds?

It is, observed Mr. Galloway, the peculiarity of life insurance with its guaranteed coverage for a lengthy period as the risk deteriorates, its heaped commissions to recognize the concentration of the agent's efforts at the initial sale, and its increasing or level premiums generating surrender values, that makes the replacement question so vexing. In an environment in which risk classes that once seemed reasonable and practical no longer appear so (e.g., the advent of non-smoker and investment generation classes), companies face the dilemma whether to tolerate a situation wherein a sophisticated policyholder can exercise advantageous rights that the unsophisticated will fail to recognize, or whether to exacerbate their own problem by encouraging the latter to follow suit.

A Joint Committee of the Canadian Life and Health Insurance Association and the Life Underwriters Association of Canada studying this problem recognized the field position: (1) the agent is a professional advisor who must disclose substantially advantageous replacement opportunities to his client; (2) since agency remuneration aims to reward accomplishment, salesmen should be paid for justifiable replacements, and companies should make some practical offer removing substantial disparities between old and available new business. The companies recognize the validity of these arguments but are concerned over lost investment opportunities caused by increased surrenders and decreased surplus, reducing their capacity to write future new business. Various compromises have been suggested, all based on the principle that the agent should receive something for his service but that inhibitions against devoting too much time and effort to this are warranted.

Prof. Belth, stressing that almost all his research has been on United States practices, views the typical life company as engaged in two primary activities: (i) that of a financial intermediary, and (ii) that of hiring, training, and trying to keep good life insurance agents. It's the agent, not the company, that's in the business of selling life insurance.

And since it takes a high order of salesmanship to persuade people to buy a product associated with death, the companies in their role as major financial intermediaries must necessarily be in the business of hiring, training, and trying to keep good agents; it is level premium life insurance that has placed them in that role. Now that this product has become incompatible with economic conditions, companies are designing contracts that shift some financial risk to the policyholder, a new relationship that has to be accepted if life companies are not to decline in importance as financial intermediaries. The implications, for agent training and for disclosure requirements, of this shift are staggering; problems of comparing sales illustrations by two companies, one that allocates investment income by portfolio average and the other by an investment year method, or one using a fixed policy loan interest rate with direct recognition and the other a variable rate, are examples of this.

Prof. Belth's answer to the first program question, as worded, was "no". While it would be generous for the company to advise policyholders to select against it, he didn't believe the policyholder could reasonably expect to receive such advice. His anwer to the second was also "no"; he saw nothing inherent in the corporate form making either type of company necessarily superior in financial strength, price or quality of service. His answers to the third and fourth questions were "yes", but with those large implications for agent training and for disclosure requirements.

Panelist Fryer began by considering the problem from the viewpoints of the company, the policyowner and the agent, noting the different time horizons of the first two. The decision to replace must be a balanced one and often isn't clear-cut; for one thing, the new Canadian tax laws expose the policyholder to the risk of more onerous taxation both before and after disposition of the policy. The agent must arm himself with product knowledge, must avoid being overly swayed by compensation, and must help his client keep his products appropriate for the long term, which might or might not mean replacement. But actuaries cannot expect the agent to stray far from his prime economic motivation.

The company has to choose between a program of response—creating higher expenses offset by public relations and persistency gains—and creeping losses in earnings and agent morale if nothing is done. The actuary probably should speak for the old policyowners first; they might have no other spokespersons.

The second question he found difficult because the distinction between stock and mutual companies is so blurred. Even though starting from different viewpoints, companies might well reach identical conclusions. They should, at the very least, facilitate periodic reviews of policyowners' insurance programs.

Nonguaranteed cash value products are sold successfully in Great Britain, but there insurance premiums are in large part tax-deductible, the investor's range of tax-favoured choices is not wide, and illustrative materials emphasize maturity values more than surrender equities. Although Canada's tax structure differs and its financial alternatives are more varied, guarantees seem not an essential element in the Canadian life insurance product. Buyers are accepting Universal Life with its minimal interest rate guarantees, and today's savings market has marked short-term orientation. A capital guarantee, though, does seem necessary, and many purchasers still want cash value guarantees. □