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GROUP LIFE INSURANCE WITH PAID-UP VALUES

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JOSEPH W. MORAN:

Mr. Espie's very thorough study and summary of the fundamental features of group paid-up is presented from what I consider a traditional point of view. It describes the usual practices of most companies as to design of the plan, schedules of insurance, schedules of employee contribution rates, and underwriting requirements. I should like to describe a somewhat different approach to paid-up, which appears to me to afford the greater degree of flexibility required to meet the diverse objectives and needs of employers in the group market. While it is somewhat novel, I believe it is just as sound from an underwriting point of view as the traditional approach.

My approach starts with a definition of a group paid-up program according to the following fundamental characteristics:

1. Provision for group term insurance for active insured employees on a schedule of amounts defined by earnings or position. The amount of term insurance does *not* reduce while the employee remains active and insured. (The employee makes no specific contribution for term insurance, but he is insured for the full schedule amount only if he participates in the other portion of the program; hence the term coverage is not truly noncontributory in the sense of automatic 100% participation.)

2. Provision for termination benefits in the form of cash or paid-up insurance in any amount determined for each individual at his termination of active insured status by his history of contributions to the program. All employee contributions are earmarked for the funding of these termination benefits, but they are applied only at termination.

3. Application each year of a portion of the reserves accumulated for present insured active employees toward the funding of future termination benefits as a supplement to current premiums for term insurance in financing the cost of current term coverage. Thus the term premium rates otherwise required may be reduced gradually as the funding of termination benefits progresses.

From this definition, we may establish underwriting practices for paid-up programs to allow us to work toward the two *separate* objectives of

each employer prospect: (*a*) a group term plan with a proper schedule of amounts of insurance for insured active employees, and (*b*) a program for funding termination benefits at a suitable level for retiring and other terminating employees.

The considerations guiding the design of the group term portion of a plan are exactly the same as for standard term plans. Recognition must also be given to the additional expense incident to the inclusion of the termination benefit features, and to the progressive decrease in margins to cover expenses as the term premium rate decreases. Thus stiffer minimum underwriting restrictions must be placed on amounts for individual lives and on the total amount of insurance, to assure adequacy of the reduced expense margins to cover the increased expenses. However, the schedule of insurance provided for active insured employees *need not* be related in any way to the schedule of employee contributions, although it usually is.

The design of the termination benefit portion of the program depends on the level of benefits desired as an objective by the employer, the willingness and ability of employees to make contributions at the level required to fund these benefits, and the degree of complexity of contribution scales which can be handled by the employer's administrative organization. Another factor will be the extent to which the employer expects reserves for termination benefits to reduce his term insurance costs.

The employee contribution scale should be designed to fit these specifications and need not be related in any way to the schedule of amounts of insurance. However, it is reasonable to require a minimum contribution of $1.00 (or more) per month for any employee who will subsequently be entitled to termination benefits based on these contributions. (Any underwriting requirement requiring a uniform contribution rate per $1,000 or limiting employee contributions to a minimum monthly rate per $1,000 of insurance is not desirable, since it will tend less to produce higher contribution rates than to produce lower amounts of insurance. An employer whose graded schedule of benefits for active employees ranges from $5,000 to $20,000 should be free to set employee contribution rates for termination benefits at a modest level such as $2.00 per month for all employees. The contribution rate will be only $0.10 per month per $1,000 in the top class, but such a plan affords far greater financial soundness than a plan which provides only $2,000 of insurance for active employees and requires a contribution of $1.00 per month per $1,000.)

It is reasonable to permit the use of a complex scale of contributions de-

signed to produce the desired level of termination benefits for most employees, as long as the employees understand and accept it, provided the employer can handle the more complex administration of payroll deductions and maintenance of accurate records of contributions. (Such a scale could provide for variation according to entry age instead of, or in addition to, salary class.)

There is also no important underwriting or actuarial reason to prohibit individual employees from electing to make additional monthly contributions for the purpose of developing additional termination benefits. The permissible amounts of extra contribution should be modest enough to avoid accumulation of additional paid-up insurance in amounts large enough to represent antiselection or deviation from the objectives of the plan. (Such provision might apply only to older employees and permit them to contribute at double the standard rate to make up for the shorter period available for funding termination benefits; if this feature is optional to the individual, the required contributions will still be within other employees' ability to pay.)

This approach appears to simplify the problem of revision of an existing group term program to a paid-up basis. Such a revision represents no more than insertion of a provision modifying the old plan to provide for crediting termination benefits with respect to all or on certain parts of employee contributions made after the change in plan. Existing coverage remains on a term basis without change until termination of active insured status. The treatment of individuals not electing to participate in the termination benefit portion of the program is simplified.

The question of term insurance for new employees who have not yet met the waiting period for paid-up and for employees in classes not eligible for paid-up is also somewhat simplified on this approach. All employees have term insurance on a similar basis while active and the only special provision required is a definition of which contributions by which employees will be recognized in determining the amount of termination benefit. Transfers between the classes accruing and not accruing termination benefits do not require cancellation or reinstatement of paid-up coverage, since it has not yet been created.

The greater flexibility of the approach described above carries with it the burden of increased complexity of sales and administration. The standard illustrations of trends in employer cost lose their applicability when contributions do not bear a uniform ratio to amounts of insurance. The approximation techniques used in premium billing become less exact and modifications may be needed in some instances. Plans may become harder for employees to understand.

As a consequence of these considerations, the approach to paid-up described in this discussion may not prove to be as effective as the traditional approach. However, I feel that the opportunity presented for greater flexibility of design to meet the needs of the market warrants study of paid-up from this alternate perspective to round out the picture so ably drawn by Mr. Espie.

WILLIAM W. KEFFER:

Mr. Espie's article is a timely one in view of the increasing interest of policyholders and employees in the group insurance benefits of all forms available to them after retirement. That there is a market for the form of paid-up life program described has been amply demonstrated. It seems to me, however, that in the enthusiasm which has accompanied its development perhaps some of the disadvantages have not been sufficiently emphasized, and in turn the provision of retired benefits on an essentially term basis has been somewhat maligned.

Mr. Cammack's paper some years ago provided convincing demonstration of the extremely high cost of continuing on a term basis after retirement all, or a high proportion, of the amounts of insurance available to active lives, but it does not lead one to the conclusion that term insurance is unsuitable for providing more modest benefits after retirement. In fact, the simplicity of term insurance administration, and the relatively low overhead costs involved, may recommend it, or some modification of it, along the lines of Mr. Trowbridge's "One Year Term and Pension Funding" (*TSA* VII, 277), over the plan Mr. Espie described. It appears that the tax problems in cost-leveling efforts along these lines may not be incapable of solution.

Some of the features of a "Group Life Insurance with Paid-up Values" program which might be questioned are:

1. *Relatively high administrative costs.* Higher employee contributions tend to obscure the true over-all costs of the detailed individual records and special handling necessary. It seems possible that these costs can exceed two times the administrative costs per $1,000 of coverage of comparable term plans, and that higher costs will continue indefinitely. Furthermore, the assumption by the insurer of liabilities many years into the future can be expected to result in more conservative experience rating, aside from the problems of equity discussed by Mr. Espie.

2. *Possible undesirability of surrender values.* Payment of surrender values does not seem to contribute toward the objectives of the paid-up program, but does add greatly to its complexity.

3. *Tax cost of employee payments.* Employee contributions are made

from wages on which individual income taxes will be paid. One year term provision of retired benefits by the employer would therefore be less costly, if this factor is given weight. But of course both employer and employees should properly value such benefits in any wage considerations, if the employer assumes this considerable burden. The tax argument is among those used by organized employee groups in pressing for full payment by the employer of group insurance costs, and these may offset the features that Mr. Espie suggests will appeal to unions.

4. *Lack of flexibility.* The narrow mold—in terms of relationship between retired and active benefits and premiums, difficulties with disability benefits, and so forth—into which a paid-up program is forced to meet the underwriting standards its nature imposes, may mean that the result does not always meet the true insurance needs of the group in question.

W. RULON WILLIAMSON:

Mr. Espie's paper seems to show that provision of insurance protection when death is most frequent and earned income is negligible is being made by people ahead of time when they are given the chance. I read this paper the day a young bachelor and his father dined with us, arriving in the youngster's Cadillac. Some one must have sold him the $1.30 article instead of the sixty-cent one.

When the company with which I used to be connected was really pushing salary allotment, and before Mr. Espie's company got the one-twelfth annual premium out of circulation, the average salary allotment contract was larger than the average ordinary contract in the year's sales. I used to tell the field men in the school, "When you sell the *little* policies under $10,000, there are easier medical requirements, but don't let that stand in the way of more adequate protection."

There is a faint suggestion here that the simplicity of a contract standing fully upon its own feet might appeal to our large-income citizens, had they not been so fully indoctrinated with the idea: "You can afford to buy a big car with your own money, but you need a subsidy when it comes to insurance and thrift."

B. RUSSELL THOMAS:

Mr. Espie has given us a comprehensive description of this form of group life insurance coverage which has become more and more important in the past few years. His paper should be of considerable interest to actuaries who are in any way associated with this form of coverage, and should be required reading for group field men employed by companies writing this form of coverage.

His presentation of the underwriting requirements and problems is excellent, but it cannot be emphasized too strongly that the underwriting standards must be higher for this form of insurance than the minimum standards applicable to group term life insurance, because of the manner in which the "money back" guarantee of employee contributions cuts into the margins which would be available under a term insurance plan. A "book" loss will occur in the first year under the majority of policies. Such loss may be recovered from subsequent margins, if the case is large enough to produce such margins, is kept in force for a number of years, and has a low rate of turnover. Termination of the master contract within a few years, or a high rate of turnover among covered employees, reduces the fund for the case not only by the amount of the cash values paid out but also by the expense of paying them, and converts the "book" loss into an actual loss.

One characteristic of this form of coverage which seems to be inconsistent with the "traditional" approach is the pattern of cash surrender values. The pattern of increasing rather than decreasing surrender charges appears to be dictated by (1) the practical necessity of the "money back" feature in order to make the plan salable and (2) the simplicity of administration, which results from using the sum of the premiums as the cash surrender value until an employee has been included in the plan for 5 years or more.

Although this form of coverage is highly desirable in many situations and will undoubtedly become more popular in the future, I heartily agree with Mr. Espie that it cannot be expected to replace conventional term insurance.

JOHN K. DYER, JR:

Mr. Espie has given us a complete, accurate and well-written summary of all essential aspects of group paid-up insurance—a veritable handbook on a form of group insurance that has, since its introduction some 15 years ago, grown quietly but steadily even though the actuarial profession has practically ignored it. My only real criticism of this paper is that it is long overdue.

The only point at which I would differ with Mr. Espie is in his apparent emphasis on a standardized relationship between employee contributions and insurance. My concept of group paid-up is that its primary usefulness is as a device for funding postretirement insurance. The fact that it produces employee equities is an important and useful by-product that makes higher contribution rates salable to employees. The level or decreasing employer cost is a by-product which makes the high initial

cost (in comparison with contributory group term insurance) acceptable to employers.

With the primary function in mind, the first approach to determination of the appropriate employee contributions should be on the basis of the postretirement insurance objective. Theoretically this approach could be made quite independently of the insurance schedule for active employees. Practically, however, employee contributions must be related to the insurance in effect while the employee is contributing, but the rate of such contributions should still be a function of the primary objective, the postretirement insurance.

For example, a company with a fairly liberal insurance schedule—say two years' pay—may conclude that 20% or 25% continuation after retirement is adequate, in which case employee contributions of $1.00 or even less per $1,000 will be adequate. At the other extreme, an employer who has provided liberal but unguaranteed continuation after retirement under a group term plan may find that a guaranteed continuation of 50% or better, requiring employee contributions of $1.50 or over per $1,000, represents his only hope of ultimate full recovery from a difficult situation through the group paid-up route. Thus, any tendency to "standardize" the employee contribution rate at $1.30 or any other figure will tend to impair the full usefulness of the inherently flexible group paid-up medium.

I should like to add one important advantage of group paid-up to those mentioned in Mr. Espie's summary: it commits the employer to a substantial and continuing cost for employee life insurance. Many employers have been embarrassed by low or vanishing group insurance net costs, and have had to reduce employee contributions to force the employer contribution to reappear. This has often been done in the presence of large and growing commitments, neither funded nor formally recognized, inherent in the promise of substantial postretirement continuation of term insurance. The employer has realized the anomaly in this situation, but has had no recourse within the group term medium. Group paid-up seems to be the best answer that has thus far appeared.

(AUTHOR'S REVIEW OF DISCUSSION)

ROBERT G. ESPIE:

Mr. Moran describes a plan having greater flexibility than the "traditional" plan outlined in my paper. The essential differences seem to be that the term portion of the total insurance does not decrease, employee contributions are not applied to buy paid-up prior to termination of

active service, and employee contribution rates are not rigidly linked to insurance amounts. What happens to employee contributions at death is not clear to me, and similarly I do not see how a portion of the funds built up by the employee contributions can be used to reduce current term insurance costs while *all* employee contributions are held earmarked until termination, unless the contributions of deceased employees are retained in the plan.

With such a plan it is, of course, possible to establish goals for provision of termination and retirement benefits quite independent of death benefit coverage. Whether such goals should be established and whether they can be attained are different stories. Our concept of termination benefits has been that they are fortuitous results of a plan designed primarily to provide money at death; hence there is no point in establishing goals for such benefits. The accumulation of sufficient paid-up at retirement is similarly a secondary rather than a primary objective; hence we recommend that programs of minimum death benefits after retirement be fulfilled by continuing sufficient term insurance after retirement, a device which has a self-liquidating character in a reasonably-designed plan.

A set of contribution rates designed to produce specific amounts of paid-up at retirement is not practical, since it is very hard to cover the question of missed payments during temporary lay-off and in any event changes in tabular paid-up purchase rates and the effects of dividend distribution or experience-rating must also be considered.

It should be noted that the idea of keeping the amount of term insurance unchanged regardless of the history of contributions could not be expected to simplify the administration of a paid-up plan as much as might be supposed at first glance. It is in the area of the record-keeping with respect to employee contributions that particular care has to be taken to keep administrative costs at a minimum.

It may be true that there are no technical underwriting or actuarial reasons for prohibiting employees from electing, within very wide ranges, the amounts they will contribute, either for Mr. Moran's plan or for the plan that I have described. However, we have steadfastly rejected requests for optional contribution rates because they violate fundamental premises of a good group plan, namely, that the employer must decide in a nondiscriminatory fashion what plan is best for the large majority of his employees who have no facilities for informed selection, that the plan must be uniform and simple in order to be economical, and that options cause trouble. Options cause trouble because, no matter how carefully they are explained and the decisions are recorded, life con-

tingencies are not predictable for the individual and ex post facto reasoning can readily be used to prove that the original explanation of choice was inadequate. Furthermore, there is a point beyond which the technical reasons must apply and insurance commissioners may feel that the establishment of such a point should not be left to the sole judgment of the underwriter, driven by competitive forces and influenced by tax considerations.

Mr. Moran has illustrated how a paid-up plan could be varied to meet unusual requirements. My purpose was to describe a plan suitable for large-scale sales.

Mr. Keffer is right in recommending control of enthusiasm for this comparatively new plan. I would suggest, however, that employer interest in a plan of this type is not generated solely by its ability to help solve the problem of continuing insurance for pensioners. A very considerable amount of employer interest arises from simple consideration that the plan actually does provide "money-back" benefits for employees who terminate and cannot cost the employer as much as a noncontributory plan. The actual percentage of our sales which have been determined solely by the ability of this plan to take care of pensioners has been proportionately small and generally limited to the largest employers. If in this area the employer can effectively plan to continue a modest amount (say, less than 25%) after retirement, we might have serious doubts as to whether paid-up is appropriate. Fortunately for the future of paid-up, there seems to be a considerable volume of effective demand for continuation of more than 25%.

Mr. Keffer's comments on costs are appropriate even though we do not feel that any kind of insurance having higher per $1,000 costs than group term life insurance is *ipso facto* a fraud upon the public or a breeder of future trouble. Uniformity and simplicity of plan and administration are essentials of keeping costs of this plan within acceptable bounds.

Mr. Williamson's encouragement at the sight of people reacting favorably to an opportunity to pay now for future benefits would be even greater if he could hear the comments of employees themselves. He might even be encouraged to see the degree of acceptance of this plan amongst employees in large-income brackets.

Mr. Thomas is in agreement with us in his statement that underwriting must be more careful. There is usually enough conservatism in the rates to write off an initial deficit within a very short period of years, but the underwriter must exercise more than usual care to avoid issuance to a group if there is a chance of discontinuance at an early date. The pattern of cash value determination is, as he suggests, determined by practical

considerations rather than by principles which have gained influence in the ordinary life insurance business.

I should also like to express my appreciation to Mr. Robert J. Myers for having drawn my attention to two inaccuracies in my paper. He informs me that social security account numbers are not useful for tracing payees because of Social Security Act provisions regarding confidentiality of records. Also, he points out that group insurance premiums paid by an employer in such manner as to create additional income tax burdens for an employee do not necessarily create additional social security tax obligations.