TRANSACTIONS OF SOCIETY OF ACTUARIES
1965 VOL. 17 PT. 2 NO. 47 AB

DIGEST OF SMALLER COMPANY FORUM— NEW YORK REGIONAL MEETING

AGENCY

A. What methods of subsidizing new managers or general agents are being used in scratch agencies and established agencies? What type of performance standards are required in determining when a new man should receive an increase or decrease in compensation or be terminated?
B. Is the manager or general agent required to share in losses on agent financing, and how is his share of the loss determined?
C. What research has been done on the cost of developing new agencies? Have any cost standards been determined?
D. What methods have been found successful by life companies not connected with property companies in developing life business from general insurance firms? What problems have been encountered by life subsidiaries of property companies in attracting life business from brokers of the parent company?

MR. J. STANLEY HILL: In the Minnesota Mutual Life Insurance Company we pay to a new general agent an office allowance of $500 per month for the first 12 full months under contract, if $1,000,000 of new business is anticipated during that period. If less business is anticipated, the allowance is proportionately less. The allowance per $1,000,000 of business reduces to $400 per month the second year, $300 the third year, $200 the fourth year, and $100 the fifth year always subject to a maximum total payment of $500 per month. The agency which grows progressively to $5,000,000 or more of production in the fifth year receives the maximum allowance for five years. After that, its volume is sufficient to finance it adequately. The agency which fails to develop receives a tapering allowance whose discontinuance in the fifth year leaves little financial trauma. Ideally, such an agency has been replaced with a more virile operation, but this is not always so. No specific validation requirements exist for new general agents.

In addition, the general agent receives a recruiting allowance equal to 50 per cent of the first-year commission on business produced by agents under contract less than two years. This allowance, together with his regular margins, enables the general agent to spend considerable time in training new men since he "makes a dollar every time the agent makes a dollar."

It is too early to tell whether a satisfactory percentage of these new recruits will attain success as measured by longer-term standards. We are making an unprecedented effort in agency profit studies to determine our rate of return on this additional investment in agency development.

MR. RALPH E. EDWARDS: Baltimore Life is primarily a debit agent company. We promote promising agents to the lowest level of supervision, called a staff superintendent. Promising staff superintendents are promoted to traveling supervisors and then to managers. When a manager's job opens up, the particular district may be big or small, and it could create a problem to have one traveling supervisor get a high-paying manager's job and the next man a low-paying one. This we solve, in part, by having the base pay for a manager set at $150 a week.

It follows that what we classify as a subsidy is any additional pay above the $150 a week. This we set at between $25 and $75 per week depending on living costs and other considerations. This is not subject to a specific uniform validation schedule, but our close supervision determines whether the new man is making satisfactory progress or not; if not, the guarantee may be reduced or the manager replaced. We have even had cases where the guarantee was increased.

Our standard compensation formula for an agent pays him rather promptly half of his first-year new sales commission on debit business, and the other half is paid over the second six months as the premiums are collected. On the other hand, in scratch agencies we use a formula where the agent's full first-year new sales commission on debit business is paid promptly. The reason I am mentioning agent's compensation is that the manager gets a portion of his pay as a percentage of agent's pay, so agency growth pays off faster in a scratch agency than in a standard agency.

MR. WILLIAM R. BATTLE: At Shenandoah Life Insurance Company we operate principally on the branch-office system. Our branch-office managers are compensated under an incentive-type contract. About three-fourths of the income under this contract is composed of a basic salary which is determined as a percentage of credited first-year commissions in the agency during the preceding calendar year. The remainder of a manager's compensation comes from increased salary for achieving certain persistency levels in his agency and from bonuses for first-year commissions paid to agents during their first three contract years. During the early years of an agency's existence the application of this contractual compensation would produce virtually nothing for the manager, and a subsidy is necessary for a temporary period.

The period during which the manager's compensation is subsidized is three years. He is paid a uniform monthly salary, and all compensation which the regular manager's contract would generate is retained by the company. The amount of the uniform salary is determined as approximately the amount which the manager should earn under the regular contract in the fourth year if he has built his agency to the minimum goal which is set for him.

That minimum goal is $2,000,000 paid volume credit in his third full year with a fairly high persistency level. Volume credit is determined as $1,000 for each $12 in annualized first-year commission on individual life and health insurance and annuities. No credit is given for Group insurance.

There are additional elements in a new agency manager's arrangements which could be regarded as a sort of subsidy in addition to the salary which he receives.

1. He is furnished a clerical staff, office facilities, and travel and entertainment expenses.
2. He has authority to contract and finance as many qualified new agents as he can find.
3. He can receive an additional subsidy in the form of assistance in training and recruiting new agents.

The home office attempts to control the recruiting and financing of agents by three principal factors.

1. The actual volume of business produced—to be certain that with the agents under contract and those likely to be recruited in the future the production goals can reasonably be met.
2. The rate of recruiting and retention of new agents—to be certain that a shortage of agents will not prevent attainment of goals although production to date has been satisfactory; to be certain that the training of new agents is sufficient to give them reasonable chance of success; and to be certain that the retention rates are not so low as to prevent the agency from ever operating profitably.
3. Persistency—so that if the agency does achieve its production and manpower goals, the quality of the business will not be so poor that the agency still cannot operate profitably.

Because of the variation among agencies in the type of men recruited, a lot of individual judgment is necessary in these assessments. Once it is determined that an agency manager will not achieve minimum goals there is little choice except to terminate him. Usually the goal is set at a level below which the fixed rental and clerical costs will not be covered, no matter how little the manager is paid.

MR. GEOFFREY F. N. SMITH: At American Mutual Life we provide our new general agents a guaranteed monthly income reducing over a four-year period, which is in addition to the contractual earnings under the regular general agent's contract. At the same time, we will pay, on a reimbursement basis, office and clerical expenses up to a maximum level which we feel the general agent will be able to qualify for on a formula basis within three or four years. Our general agent's first-year overwriting is based on cash commissions earned in his agency so that with substantial monthly writings his income from this source tends to be deferred. His contract includes quite substantial renewal overwriting commissions which, also, take a few years to build up. In total, therefore, we feel that a four-year subsidization period is almost essential, and this is borne out by our past experience under other plans.

While we do set performance standards in the form of recruiting activity, volume of business expected and premiums paid, it is extremely difficult to enforce these requirements rigidly over short periods of time. It is our feeling, therefore, that our new subsidization plan is to some extent self-policing, since the reducing monthly income not only puts pressure on the general agents to obtain results but automatically assists us in our postselection. It also avoids some of the problems involved in increasing or decreasing compensation, since this is handled automatically under the contract.

In summary, we expect to continue to have problems with marginal new general agents, with having to make additional advances hopefully secured by future commissions and probably to continue retaining some general agents longer than we should; but we do feel that this plan provides some automatic controls which will assist us to do a better job of supervising new general agents.

MR. MELVIN L. GOLD: Suppose you are the consulting actuary of a small newly formed company and they want to attract agents. What do you advise? You try to go after established agents. The established agents are aware of this. In some cases I have seen them being subsidized. The agents get so much a month in addition to commissions and a promise they are going to set up such agents. During the eighteen-month trial period they can receive 250 per cent commissions. After the eighteen-month trial period ends they may move to the next company.

So what can the new company do? Well, essentially, they go after personal producing general agents and offer them stock options and/or stock ownership. They are somehow hoping that if they have an ownership in the company, they will stick around and produce persisting business.

Another thing that new companies try to do is give a higher commission in the first few years, say a transitional period. This is based only on business sold, and the hope is that after a few years, when they have established some subagents, they will be able to carry on themselves. This often doesn't happen.

MR. MELVIN D. BENNETT: The Manager's Contract used in the Prudential's Ordinary Agencies has two essential parts: a base salary which in an average case will pay about 40 per cent of the manager's total compensation and overrides on first-year commissions. In addition, there is a relatively minor element which makes extra payments to the manager with respect to each agent who is deemed to be successful by receiving a certain level of first-year commissions. The base salary has a minimum of $6,000 per year, and goes higher in accordance with a table depending upon gross production credits of the agency, with an annual redetermination. Overrides on first-year commissions are paid at rates which are appropriate for each branch of insurance. On individual life and health insurance, the rates vary around the desired average in accordance with tables depending upon lapse rates and the Cost Index, which is a measure of the agency's expenses other than commissions, as related to standard unit costs.

We rarely encounter the problem of starting scratch agencies, however, we do sometimes divide existing agencies so that a new one is quite small when established. In these situations, as well as when appointing new managers to existing agencies, the manager is given the contract mentioned above. We would provide additional support only through a guarantee that his earnings for the first two years would reach a designated minimum. This minimum would be set so that the new manager would be earning slightly more than he was receiving in his previous job. Obviously, with support given for a only limited period, it is necessary that the new manager be chosen with care and that the productivity of the new agency be carefully estimated so that everyone will be happy when the third year comes along and the manager must depend upon formula earnings under the contract.

MR. WILLIAM L. BARBER: Union Mutual's financing program is filed with the New York Department under Subsection (13) of Section 213. This section provides for compensation in the form of reasonable training allowances. The main advantage of setting up such a financing plan is that the increase in debit balances resulting from the plan does not get into the test of the first-year expense limit, sometimes referred to as the "inside limit." There are limits as to the amount of such allowances and furthermore they do get into the total field expense figures.

In the write-up of this plan is the statement that "If the agent terminates, a valuation of his future commissions is made at the time of termination. This value is then deducted from the debit balance and the cost of any remainder is shared 50-50 by the company and the General Agent."

However, if a manager hires a new agent, the total cost falls directly upon the company at the time of the agent's failure. I must qualify this by saying that the manager will be required to share in the cost if the plan's experience under that manager is high in relation to a predetermined standard.

We have found that financing plans must be changed fairly often in order to meet the needs of the business. This is true because what theoretically looks like a solid plan can turn out to be impractical in operation. Another interesting question is whether the new agent being financed at say 1.5 X dollars per month should be required to produce, for validation, one and one-half times that of the agent being financed at X dollars per month. Perhaps at the end of six months or a year this should be so, but in the beginning a much smaller ratio seems more realistic.

We find that in addition to what our company plans are willing to advance each month, the general agent or manager is also financing in excess of that. Any cost developed by the excess is, of course, a direct charge to the general agent or manager.

In addition to the training-allowance plan, we also have other financing plans which call for advances based on annualized commissions and various percentages of such annualized commissions. Under these plans the general agent is responsible for all the costs, while the manager is responsible on the same basis as the training-allowance program.

MR. BENNETT: Prudential's financing plan for new Ordinary agents uses a training allowance which is paid as a salary for the agent's first eight weeks. The training allowance then diminishes sharply to 35 per cent of the original weekly amount and continues to diminish gradually until it expires at the end of $2\frac{1}{4}$ years. If the agent meets his validation schedule, the difference between the training allowance and his starting salary is made up by withdrawals from an account which is based upon potentialized first-year commissions, less a reserve equal to 20 per cent of his deferred first-year commissions. Any renewal commissions which emerge are also available for use in salary. The amount of training allowance payable in any week is determined solely from the level of the agent's starting salary. Any increases or decreases in total salary are controlled by the condition of the Potential Commission Account.

The manager shares in the company's loss on terminated agents. He is required to pay the company a fraction of the amount of training allowance paid in the agent's first eight weeks, if the agent terminates within a year. The manager's percentage gradually reduces until he has no liability if the agent remains on the plan and meets the validation schedule for at least 52 weeks.

A manager is permitted, within certain limits, to continue an agent on the training-allowance plan even if the agent fails to validate. If the manager makes such a decision, he becomes liable for 100 per cent of the training allowance paid thereafter. However, if the agent subsequently meets the validation schedule, the manager is relieved of this potential extra liability.

MR. DWIGHT K. BARTLETT III: At Monumental Life we have created models of new Managerial Ordinary Agency offices. We have been able to program the model for our IBM 1410 computer. This has allowed us to make fairly elaborate assumptions as to the hiring rates and survival rates of agents as to their levels of production and as to the lapse rates and mortality rates applicable to the policies. The model is a probabilistic model with respect to the survival rates of the agents and the lapse rates and mortality rates of the policies using the Monte Carlo simulation technique. The model computes year by year the number of agents currently employed in the office, the current year's production and business in force, the premium income, claims, cash value payments, commissions, other field and home office expenses, and values for business in force at the end of each year so that we are able to determine the impact on the company's surplus year by year. The probabilistic nature of the model gives results which vary substantially from simulation to simulation. Therefore the model also computes the average from a sequence of ten simulations. The advantages of the probabilistic nature of the model is that it does give us some feeling for variation in results from one office to another. It also allows us in a particular simulation to deal with whole agents and whole policies instead of fractions which would result from a deterministic application. The advantages of having the model programmed for our computer is that we can change the assumptions easily to determine the effect of the change. We found, for example, that the model was extremely sensitive to a rather modest improvement in the survival rates of agents.

While we were very pleased with the techniques we were able to employ in creating the model, we were disappointed in the results in terms of the projected profitability of a new office to the company. Even with the full marginal effect of the office on our federal income tax, it is difficult to make the model show a profit within a reasonable period of time under assumptions which we feel are typical for our company. I am including in this discussion the assumptions we made for a typically successful office and the results which we received from our program as an average of ten simulations. It appears that in order to justify expansion you have to put a great deal of weight on the present value of future profits in existing business. We have valued business at $15 a thousand. On this basis the model shows a profit in the fourth year, even though without the value of increase it is still showing a loss after ten years.

ASSUMPTIONS:

I. *Personnel*

Agents hired as follows:

Calendar Year of Agency	No. of Agents Hired
1	3+1 manager
2	6
3	5
4	7+1 supervisor
5	7
6	7
7	9+1 supervisor
8	9
9	9
10	10+1 supervisor

Agent's survival rates as follows in successful agency:

Agent's Contract Year	Survivors as Percentage of Original Hirings
1	30.0%
2	21.0
3	16.8
4	14.3
5	12.6
6	11.7
7	10.8
8	10.0
9	9.4
10	8.9

II. *Production*

Production of career agencies is as follows:

ANNUAL PRODUCTION RATES (FACE AMOUNT OF POLICIES AND RIDERS IN THOUSANDS)

	CALENDAR YEAR SINCE APPOINTMENT				
	1	2	3	4	5
Managers	$150	$350	$350	$350	$350
Agents:					
Successful	$150	350	448	550	625
Unsuccessful:					
1st cal. yr.	$ 30	...	...	...	...
2nd cal. yr.	$150	150	...	...	...
3rd cal. yr.	$150	350	150	...	...
4th cal. yr.	$150	350	448	150	...
5th cal. yr.	$150	350	448	550	350
Agents who fail after the 5th year do $350 in the year of failure					
Supervisors	$350 all years				

Production was distributed by plan as follows:

Plan	Per Cent of Total Face Amount
Whole life	44%
L.P.U. @ 88 (High cash value)	12
End. @ 65	6
20-Yr. Decreasing term policy	10
5-Yr. Renewal term	8
20-Yr. Level term rider	20
	100%

Average issue age 38. (This gives an average premium of $16.63/M of initial amount.)

Reserves are computed on the CRVM basis, except for the high cash value policy which is on a net level premium reserve basis. The table used for reserves is the 1958 CSO, 3 per cent. The policy experience is as follows:

Table X-18 with BAT 5-year Select Modification.

4½ per cent (before federal income tax).

200 per cent of Linton A first two policy years, 150 per cent of Linton A third year, Linton A thereafter except that business orphaned by termination of the writing agent in his first calendar year of service will experience 50 per cent first-year lapse rate.

III. *Field Expenses*

Career agency expenses as follows:

Each manager receives an annual salary plus promotional allowance as follows:

Calendar Year	Salary*	Promotional Allowance
1	$ 5,500	$ 600
2	11,000	1,350
3	11,500	1,650
4	12,500	1,950
5	13,500	2,250
6	14,000	2,400
7	14,000	2,400
8	14,000	2,400
9	14,000	2,400
10	14,000	2,400

* Or 10 per cent of first-year premiums, plus 5 per cent of second- and third-yr. premiums, plus 2 per cent of fourth- to tenth-yr. premium, if larger.

Each manager receives fringe benefits equal to 5 per cent of annual salary. Each manager receives a recruiting bonus of 5 per cent of premium produced by agents in their first 3 years under contract after his annual salary according to the formula exceeds the flat amount.

New agents receive a monthly allowance of $500 less earned commission during their first 3 years under contract. Agents terminating in first-year average four months under contract (five months in unsuccessful agencies).

All agents receive fringe benefits assumed to be 5 per cent of annual earnings.

Each agency is assumed to have overhead expense as follows:

Year	Overhead
1	$ 8,000
2	10,500
3	11,500
4	12,500
5	13,500
6	14,500
7	15,500
8	16,500
9	17,500
10	18,500

Each agency supervisor is paid additional compensation of $400 a month.

IV. *Home Office Expenses*

Home office agency supervision expenses are $4,700 per year. Home office underwriting, issue, and administrative expenses are:

1st year	$15.00 per policy and $1.50 per thousand
Renewal	$3.75 per policy and 8¢ per thousand

MODEL AGENCY—AVERAGE OF 10 SIMULATIONS

(000 omitted in dollar figures)

Calendar Year of Agency	No. of Agents Employed 12/31	Production	In Force 12/31	Premium Income	Claims and Cash Surrenders	Increase in Reserves	Agent's Commission	Agent's Financing	All Other Expenses	Investment Income	Profit before Federal Income Tax	Federal Income Tax	Profit after Federal Income Tax	Value of Increase	Profit plus Value of Increase
1	1.60	$ 393	$ 372	$ 7	$ 0	$ 2	$ 3	$ 6	$ 18	$ 0	$−23	$− 7	$−16	$ 5	−11
2	3.50	1,114	1,352	26	2	9	10	15	32	− 1	−44	−15	−29	15	−14
3	4.60	1,602	2,633	51	3	19	16	18	37	− 2	−44	−17	−27	20	− 7
4	6.50	2,615	4,713	91	6	37	27	22	48	− 2	−51	−22	−29	32	3
5	7.70	3,492	7,356	139	15	59	36	25	55	− 2	−52	−25	−27	38	11
6	9.00	4,093	10,275	192	26	85	45	24	61	1	−49	−26	−23	43	20
7	10.20	4,815	13,623	259	38	120	56	29	78	4	−58	−32	−26	54	28
8	12.50	5,312	17,151	333	43	159	67	31	89	9	−47	−33	−14	60	46
9	13.30	5,966	21,037	415	52	202	78	34	100	16	−35	−32	− 3	66	63
10	14.90	7,040	25,575	503	82	247	90	34	116	25	−40	−36	− 4	72	68

MR. JOHN S. THOMPSON, JR.: I assume that by "company cost" we mean the amount of subsidy involved in managers' and soliciting agents' compensation and in the cost of maintaining an agency office, rather than simply the gross amount of these costs before deducting the value of the business produced under the plan.

In order to measure these costs, we at North American made assumptions with respect to the following factors:

1. First, there is the manager's compensation and the cost of operating the agency office. In their Research Report #64-7, LIAMA presents the results of a survey among a number of companies operating on a managerial system.

For our studies we have assumed that managers' compensation will average $12,000 in the first year and must be expected to increase by $1,000 annually thereafter.

As to the cost of the operation of an agency, it appears from published LIAMA data that the average cost, excluding managers' compensation, will be in the neighborhood of $25,000 to $30,000 in the first year. This can be expected to cover rent, the salaries of supervisors and clerks assigned to the office, and certain miscellaneous items. We assumed that the first-year cost will be $25,000 and will increase at the rate of 5 per cent each year.

2. Second, we have assumed that the average agency will produce $1,200,000 in the first year, increasing to $6,400,000 in the fifth year.

In order to measure the commission and expense margins in the premiums we have used the company's regular asset share assumptions.

3. Finally, a key factor affecting the cost of new agencies to the company is the probability that new managers will be successful. Survival rates of managers in a company that has been established on the salaried managerial basis are probably very high because managers are appointed only after a period of service in other management positions. In a new company, however, the termination of managers who do not meet the company's production standards is certainly a factor to be considered. For our purposes we have assumed that the termination rate will be about one-half the corresponding termination rates among soliciting agents—starting at 30 per cent in the first year, 24 per cent in the second year, 10 per cent in the third year, and declining thereafter.

On the basis of these assumptions, we have calculated the average deficit at the end of the fifth year to be about 15 per cent of first-year premiums on business produced under the plan. This is the amount by which we expect the managers' salaries and office expenses to exceed normal commission and expense margins.

Offsetting this is the value of nonvested renewal commissions on business produced by terminating agencies. This latter item can be expected to amount to $2\frac{1}{2}$ per cent of first-year premiums. To the cost of the managers' plan we must, of course, add the cost of a financing plan for soliciting agents. As to the cost of a soliciting agents' plan, we have the limits of Sub-Section 13 of Section 213 in New York law as a guide. On this basis we may assume that 30 per cent of first year's premiums can be assumed to be a reasonable cost of the agents' salary plan. The combined cost of a new agency can then be expected to be in the neighborhood of 40 per cent of first year's premiums. This, of course, is the added cost in addition to the margins already provided in premiums for compensation and expense reimbursement to general agents and soliciting agents.

MR. SMITH: At American Mutual Life we find that when all the calculations of the cost of developing new agencies have been made, the opening of the new agencies remains as much a matter of faith as of sound investment decision.

The first requirement, therefore, seems to be to have an agency department capable of selecting men who can build agencies which fall in the upper quarter, and if they can do this, the company certainly has no problem. On the other side of the ledger, there is no doubt that in an agency where a company runs through several general agents before finding one who can do the job, a true cost-accounting approach is likely to prove that the initial investment will never be recovered.

MR. BENNETT: Experience has shown that we at Prudential sometimes spend $50,000 or more in starting a new agency. This would be expended over two or three years and represents the extra cost of getting new business, over and above the costs that would arise if we were able to get the same additional amount of business from existing agencies in the vicinity. Unfortunately, managers have only a limited span of control, and agents have limited capacity for production, so we have to accept the expansion costs if we want to improve or retain our production ratios, as measured against expanding population, economic growth of an area, or some similar base.

On the other hand, we sometimes find that we can create a new agency at much less cost. Upon retirement of the manager of a large agency, for example, it may be possible to split the territory and the staff so that the new managers' agencies are almost immediately self-sufficient. This would happen, of course, only if fortuitous circumstances made it possible to eliminate or tightly control the usual costs of agency expansion:

1. Subsidy to new manager while getting started.
2. Compensation to other manager(s) for territory or staff taken away.
3. Training allowances to an unusual number of new agents.
4. Higher clerical salaries and training costs.
5. Employee benefit costs related to the above items.
6. Additional agency rent.
7. Additional furniture and equipment.
8. Increased travel or training expenses.

MR. W. TRIS STEVENS: Hartford Life, which has been a member of the Hartford Group since 1959, has had to face a number of problems because of the merger, some unexpected but at least two that were realized. First, we became a small part of a very large operation, and, second, we have grown rapidly ourselves.

While our sales have increased from $50 million in 1958 to $300 million in 1964, it wasn't as easy as some expected. With more than 30,000 Hartford Fire agents available to sell our product, some envisioned an increase in sales of several hundred per cent. We found, though, that life insurance, as a product, has to be sold to the seller as well as the buyer. And, of course, those agents that really wanted to sell life insurance already had contracts with other companies and were under no compelling reason to change affiliations.

So we had to win our increased sales instead of having them handed to us. This meant staffing a salaried field staff to contact, convince, and train all the prospective agents and increasing the Home Office staff to process the increased business as it developed. We neither discovered nor solved the problem of staffing, but we keep trying, which is all I can suggest in this very important but difficult area. The training of our salaried field staff had to include not only life insurance and Hartford Life's approach to it but also general insurance and the Hartford Fire over-all philosphy. There are more differences between life and casualty operations than many believed. And, of course, there were differences between the two companies.

Once a start on the development of the salaried field staff has been made, these men must start on development of sales. Some of the objections they must overcome when dealing with agent-brokers are: lack of motivation and time to sell; lack of time to train; and the poor public image of life insurance salesmen. Those we most want to sell for us are already successful in their chosen line—and they are busy. Where and why should time be found to train in a new subject which is certainly not simple? Where and why should time be found to sell a product that admittedly has to be sold in contrast to many of their other lines which must be bought by their clients? Why should the agents jeopardize their positions with good clients by their lack of knowledge or by using the high-pressure tactics they believe necessary to "peddle" life insurance? And, how much more money can they make by selling life insurance than their regular lines anyway?

Finally, the Home Office itself has problems. I've mentioned staffing problems—both field and home office. There are product problems to appeal to this large, country-wide field staff with widely varying needs, desires, and degrees of sophistication. And, of course, there are the premium and commission problems that go along with these product and staff requirements on top of the heavy tooling-up expenses.*

MR. JAMES A. ANDERSON: When Colonial became the life affiliate of Federal Insurance Company and the Chubb organization, I suppose there were some glowing pictures of the business that would just march itself to our doors. Definitely there are problems involved in attracting brokerage business, and sometimes these are eased and sometimes made worse by the affiliation with a parent company.

1. Any broker is interested in three things: service, product, and commission. A company licensed in New York must show superior service and product, since the commission scale in all probability will be less than that of companies not licensed in New York.

2. Somewhat related to commission compensation is the fact that some companies offer fringe benefits and stock options to brokers. This is simply an additional obstacle for the company that offers neither of these inducements.

MR. FREDERICK S. TOWNSEND: At Conning and Company we feel that while life subsidiaries of property companies will have difficulty in growing, these difficulties are not insurmountable. To the contrary, if property insurers decided that they want their life affiliates to write an increasing amount of production, I believe that no problem will exist. In many current cases we see a false illusion of difficulty merely because the executive staff of the property insurance company has not decided on a course of action to take with respect to its life affiliate. I believe that the life insurance property insurance affiliation will play an aggressive role in the future of the life insurance industry.

It is interesting to look at the twenty largest stock insurance companies, ranked by their fire and casualty net premiums written, and to note their experience in the life insurance industry. The twenty companies may be divided into four groups of five companies each.

* Discussion by Mr. James A. Anderson concurred.

In the first group are five companies with no life insurance connection. However, two of the companies are foreign-owned, one is a management group of companies and another is an automobile insurance company owned by a large industrial corporation. Only one of the five insurance companies was a true United States casualty insurer with no life connection.

The second group of five companies are all connected with multi-billion dollar in force life insurance companies. Four of these five casualty insurance companies are owned by the life company with which it is affiliated. These five companies do not truly come under the scope of the topic we are discussing.

Of the remaining ten companies, or one-half of the companies included in the study, each one of the ten casualty insurers organized or purchased a life insurance affiliate in the last eight years. The third group consists of five companies having organized life affiliates, and the fourth group consists of five companies having acquired established life companies.

In the case of the casualty insurance companies starting their own life organizations, two of these companies have entered the billion dollar in-force stage, a third company has over half a billion dollars of insurance in force, and the remaining two companies have close to $200 million of insurance in force. Personally, I would label each of these five young life companies as aggressive, rapid-growing life insurance companies.

In the group of five property insurance companies acquiring life companies in the last eight years, two of the companies have a billion dollars of insurance in force, two other companies have over $200 million of insurance in force, and the fifth company is a relatively new organization. Although the five companies affiliated by acquisition have not grown as aggressively as the five companies formed by their parent organization, life insurance sales in all ten of these companies are showing good solid gains on a year-to-year basis.

PRODUCT

A. What has been the experience under special term policies for high-school and college students as to lapse rates, mortality, acquisition costs, and conversion to permanent plans?

B. What special contracts with flexible premiums have been designed for the H.R. 10 market? What types of plans involving auxiliary funds have been introduced for this market?

C. What has been the experience on business involving bank financing of premiums for medical interns and graduate students? Does this type of business show satisfactory persistency after the financing ceases?

D. What is the actuarial justification for coupon policies? Do any of their attributes or characteristics suggest special legislative or regulatory controls over their sale?

MR. WILLIAM D. SMITH: At Philadelphia Life Insurance Company we began offering our student PLUS plan in November, 1960. PLUS is a $10,000 term to age 28 automatically convertible at that age to Ordinary Life. It includes a disability waiver of premium benefit and an option to have an additional $10,000 of insurance issued at age 31 without evidence of insurability. The annual premium to age 28 is $40, and the policy is issued at ages 16–24 inclusive. A simplified application is used, and underwriting and issue procedures have been suitably streamlined. This policy's importance to the company can be gauged by the fact that it constitutes more than 20 per cent of our present in force.

The persistency of PLUS has exceeded our expectations and in each year has been better than Linton A rates. Our experience for the most recent twelve months is as follows:

Year	Proportions of Business Remaining in Force To Enter Each Year
2	90.5%
3	85.2
4	79.6

There has been very little change in these rates when the results of successive twelve-month periods are compared.

Mortality has been within the margins assumed in the premiums. Since the beginning of our program, there have been 42 deaths, for $380,160 representing a yearly death rate by amount of insurance of 80.5 per $100,000. The total exposure is $472,290,000. Based on the 1955–60 Select

Basic Tables, taking males and females separately, the ratio of actual to expected mortality for all PLUS business is 116. Classified by cause, the deaths have been as follows:

Automobile accident	21
Other accident	9
Disease	8
Suicide (return of premiums)	4
	42

Compared to the death rates by cause revealed in the 1962 Reports, it appears we have had more than our share of accidental deaths. Considering the nature of the group, i.e., college students with automobiles and spending money living away from home, perhaps this result should not be entirely unexpected.

In December, 1964, the first few policies reached the automatic conversion date and were billed for the Ordinary Life premium. No special effort has been made to explain the increase in premium or encourage the continuation of the policy. Results are being watched carefully and a number of additional steps planned if the conversion rate turns out to be unsatisfactory. Because of the small number of policies involved, early results are inconclusive but are on the encouraging side.

While increased competition does not seem to have had an appreciable effect on our in-force business, it has had an effect on our sales during the last two years. As more and more companies solicit the same group of prospects, the effort becomes less productive and the dangers of antiselection increase. It seems likely that the day will soon come when changes in the program will have to be made to overcome these problems.

MR. RICHARD S. MILLER: American United Life Insurance Company has been marketing an annual premium convertible special term policy for college students since 1958. The policy is in \$5,000 or \$10,000 amounts and for a variable term. This term is to the July 1 six years subsequent to expected graduation according to the student's status at date of issue. The first policy "anniversary" is the July 1 subsequent to issue except for June 1 issues where the first anniversary is 13 months after issue. The first premium is a pro rata premium to the first "anniversary." The policy contains waiver of premium and a guaranteed purchase option equal to the face amount. The first option date is two years subsequent to expected graduation, and, if not exercised for the full amount at that time, the policyholder may exercise the remainder at expiry. The policy is marketed by mail solicitation at home office expense and initiative.

Our experience has been favorable as the following data indicate:

LAPSE RATES

Calendar Year	Over-all Per Cent Lapse by Amount*	Policy Year	Lapse Rate by Amount (Per Cent)
1959	7.1	0	7.9†
1960	10.9	1	10.6‡
1961	9.5	2	13.9
1962	11.8	3	20.7
1963	12.6	4	22.8
1964	12.9	5	13.7

* Total lapses as of July 1 divided by total in force on June 30.

† Lapses of July 1 divided by issues of January through May of the same year.

‡ Lapses of July 1 on issues of the premium calendar year which were still in force on June 30.

MORTALITY EXPERIENCE BY AMOUNT

Calendar Year	Death Rate per 1,000	Ratio to 55–60 Basic*	Actual Deaths	
			No.	Amounts
1958	0	0	0	0
1959	0.26	39.8%	1	5,000
1960	0.40	59.2	2	15,000
1961	0.86	125.1	8	50,000
1962	1.00	142.0	12	75,000
1963	0.67	93.3	7	60,000
1964	0.70	96.5	10	70,000
1958–64 combined	0.72	102.0%	40	275,000

* Expected was computed using a single average issue age of 18.5 and 30% female issues, both of which are our actual average results, although individual years do show variations.

As would be expected, most of the deaths were accidental.

Cause of Death	Male		Female		Total	
	No.	Amt.	No.	Amt.	No.	Amt.
Accident	20	140,000	3	15,000	23	155,000
Natural	9	65,000	4	20,000	13	85,000
Suicide	4	35,000	0	0	4	35,000
Total	33	240,000	7	35,000	40	275,000

Lapse rates in the third and fourth year are high due to two factors. Most important is that the student is now probably paying for the policy as opposed to his parents. Also, these are the policy years when our agents have been most actively soliciting conversions or replacements. We feel that many policies are shown on our records as lapses when, in fact, they were replaced but through the regular issue process.

In our opinion no more than two deaths for $15,000 would have been prevented by normal nonmedical underwriting. Directly allocable underwriting costs have been less than $35,000 on some 26,000 applications.

Acquisition Costs

Total printing, postage, addressing, and administrative costs of the mail solicitation are running about $6.00 per $1,000 paid for. In addition, first-year writing and override commissions of 12 per cent are paid, and first-year underwriting, billing, and issue costs run about $1.60 per $1,000. The solicitation costs have been rising steadily as postage rates have gone up and percentage responses have gone down. This last is presumably due to three factors: (1) resolicitation of students who have previously declined to apply; (2) the increase in competitors' solicitations; and (3) some relaxation in our "underwriting" of which students we solicit. In this respect we should mention that we will not solicit precollege students (i.e., high-school), as previous experiments yielded results of less than 10 per cent of what an equal expenditure would produce in the college market.

Conversions to Permanent Plans

Until this January our records have given us only (1) conversions or purchase options exercised where underwriting was not fully normal and (2) replacements where a refund of premium was requested. Our experience on this basis is as follows:

Calendar Year	Face Amount of Replacements, Conversion, and Option Exercises	Per Cent of Column 1 plus Deaths to Nonrenewals (Including Expiries)
1958	75,000	100
1959	185,000	16.2
1960	199,000	6.4
1961	308,500	8.1
1962	935,660	10.3
1963	1,435,000	11.5
1964	2,110,000	12.8

Since early in 1963, conversion to EDP has enabled us to supply our agency force with prospect lists of those policyholders who (1) are graduating, (2) have their first option date coming up, (3) have their expiry date coming up, or (4) gave us a change of address or beneficiary. These lists go to both the original agent and the agency manager nearest the current home address. From the enthusiasm of our agency force and the increase in total issues in this age group, we feel that total new issues of permanent insurance to our college term policyholders is far in excess of the above figures and that collateral business written on other members of the family is very substantial.

Some mention should be made of our relationship with our agency force in the marketing of this plan. Although all applications resulting from the direct mail solicitation are returned to us through our agents, we were subject to some criticism during the early years. The primary complaint was that we would recognize only one agent for any one college, thus excluding many of our agents from writing (or at least receiving commissions on) this plan. Also, there were a few mild accusations that we were "direct writing." However, now that all our agents are reaping the benefits of the excellent prospect lists, they are all enthusiastic over the plan, even to the extent of occasionally writing this plan on a personal interview, though the commissions and production credits may go to someone else. Rather than risk a prospect purchasing some other company's policy, they prefer to "warehouse" this prospect for the day when permanent insurance becomes necessary and financially practicable.

MR. PETER M. TOMPA: Two years ago when H.R. 10 plans were discussed at the Society meeting, I indicated that we were uncertain, at Guardian Life, whether Ordinary Life policies with Auxiliary Fund arrangements can be written by insurance companies to individual trustees of H.R. 10 plans, eliminating the need for a bank trustee. The key to the situation lies in the requirement of Section 401 (d) (1) of the Internal Revenue Code under which a bank trustee is essential, unless the trust uses "annuity, endowment, or life insurance contracts of a life insurance company *exclusively* (emphasis supplied) to fund the benefits prescribed by the trust. . . ." Meanwhile, we succeeded in drafting a rider, now approved by all state insurance departments (except Illinois), under which the insurer agrees to accept annually advance payments toward the cost of exchange required at the date of retirement, to change the Ordinary Life policy to a fully paid retirement annuity contract with a monthly income up to $30 for each $1,000 of face amount of insurance. This rider, when attached to the Ordinary Life policy, makes it possible to fund all benefits under the plan by a life insurance contract exclusively. A Prototype Plan was developed and accepted by Internal Revenue Service for this type of funding, under which an individual trustee purchases the Ordinary Life policy and makes additional payments to be accepted under the rider as advance payments toward the cost of exchange at retirement. The advantage lies in the flexibility of the advance payments as compared with the rigidity of the Income Endowment premiums. Incidentally, our Ordinary Life-Prototype provides for premium payments of less than 50 per cent of the annual contribution of the employer, using the "profit-sharing" type definition of incidental insurance as applicable to money purchase pension plans. During 1964 we sold 32 such plans, in addition to 94 plans using an Income Endowment type policy.

MR. CHRISTOPHER G. SMITH: In November, 1964, State Mutual of America announced its completely new pension portfolio designed primarily for use in connection with pension or profit-sharing trust cases. This new portfolio, in part, was made available also for insurance or annuity purchases by employees of Section 501 (c)(3) organizations, by employees of public school districts and by persons who meet the requirements of the Self-Employed Individuals Tax Retirement Act (H.R. 10).

Because of State Mutual's decision to use the same basic policies in this new portfolio for all these different types of sales, no special contracts with flexible premiums were designed solely for the H.R. 10 market. Instead, for H.R. 10 business where flexible premiums are specified a special rider is available for issue in conjunction with the issue of a level annual premium Retirement Income or Retirement Annuity policy. This combination of basic policy and rider provides the means for paying flexible varying yearly premiums under an H.R. 10 plan. The rider provides for the payment of a series of single premiums by the policyowner in addition to the level premiums payable under the basic policy. At the date of issue, the policyowner may elect to pay a single premium under the rider of any amount not less than $100 or more than twice the annual premium for the basic policy. On each policy anniversary thereafter, the policyowner may elect to pay on such date a single premium of any amount not less than $100 or more than twice the annual premium for the basic policy, *or* he may elect to forego the payment of a single premium as of such date without affecting his right to make subsequent single premium payments under the rider.

This Additional Deferred Annuity rider is participating and has cash values but no loan values. Its cash value at any time prior to the retirement date is the total of the net single premiums paid, each accumulated at 3 per cent interest, compounded annually to the date as of which such cash value is to be determined. The death benefit under the rider prior to the retirement date is the total of the gross single premiums paid or the rider's cash value as of the end of the policy month of death, whichever is greater. On the retirement date the then cash value of the rider is applied under the basic policy's settlement options to provide additional income to the payee.

Turning now to the second question under this topic II B, State Mutual currently offers a Prototype Plan, approved by the Internal Revenue Service, which consists of a split funded combination pension plan employing the services of a bank as trustee of the plan. The basic feature of this plan is the investing of approximately 35 per cent of each plan participant's annual contributions in life insurance or annuity policies as specified under the plan and the investing of the remaining 65 per cent of such contributions in a common trust fund maintained by a local banking institution.

This Prototype Plan, designed for self-employed individuals and for various professional, business, and trade associations of self-employed individuals, is a standardized form of pension plan which must be adopted without change except for a few areas of flexibility which may be allowed, such as eligibility provisions, methods of providing retirement benefits and death benefits, and selection of a normal retirement date. A separate trust instrument, which is part of this Prototype Plan, is executed with the bank as trustee. This trust agreement permits the trustee to maintain and administer the pooled funds under the plan, invest such funds, pay the premiums on the life insurance or annuity policies issued under the plan, and pay from the trust funds any costs at retirement to convert the life insurance policies to retirement income. It also specifies all the other conditions and provisions to be complied with by the bank as trustee of the plan.

MR. DONALD M. ELLIS: Our knowledge of this subject at Canada Life Assurance Company is limited to the experience of a very few of our top caliber U.S. agents who have specialized in the medical market.

We have no precise statistics available but of the top two producers, one has only had 1 per cent of such policies lapse over a number of years and the other has had 97 per cent persistency. The few cases which were lost were terminated for some specific reason, such as divorce, decision to enter academic medicine, etc., and the bank was completely paid off.

Experience has shown, however, that there are certain principles which must be followed to make this plan successful.

1. It appears desirable to show the prospect exactly what he is expected to pay each and every year, including a plan for liquidating the policy loan.

2. Each year the agent should send the policyholder a detailed letter which shows exactly what the man owes, to whom, and why. Otherwise, a man may forget about these debts because fundamentally no one likes to remember debts.
3. The agent should try to make sure that the policyholder understands that the bank will sue in the event of a default.
4. The plan should not be sold to a student until he is in his senior year, since he is likely to take one year of internship and three or possibly four years of residency after that before entering practice.
5. Any plan of financial insurance must compete mathematically with term insurance converted as of attained age. If it will not so compete, there is potential trouble, since the policyholder may find out and claim misrepresentation.
6. Plans which call for payment of interest only are dangerous, since a man tends to buy too much and build up too much debt. A cash payment of two or three dollars per thousand per year seems desirable. If he cannot afford this much, there is a good likelihood that he should not buy at all.

In summary, our limited experience shows that if this plan is carefully and honestly presented with due regard to the interest of the purchasers, and with proper follow-up, it is excellent business with a very high rate of persistency both during and after the bank financing.

MR. RICHARD D. FINK: Provident Mutual formally entered the field of bank financing of premiums in November, 1961. We have worked through one bank in Philadelphia, and our statistics are based entirely on business financed through this bank which cooperated in developing our plan. However, some of our agents have made their own arrangements with banks in their cities.

The bank will finance the premiums for medical and dental students in their last two years, for interns and residents, and for doctors during their first two years of practice. The minimum amount issued is $15,000 and the maximum $100,000. Disability premium waiver is required. Term policies cannot be used, but a 10-year-level term rider may be included for an amount not exceeding the amount of permanent insurance. The note must be indorsed by the agent but not by the agency manager or a general agent. The average bank loan is currently over $1,700. To help protect its loans, the bank requires that an amount equal to 10 per cent of the premium be withheld from the first-year commission and placed in escrow; a separate escrow fund is maintained for each agent.

During the $3\frac{1}{3}$ years which we have been in this field, 872 cases for $36,700,000 face amount of insurance have been sold on this basis, representing an average amount of insurance per case of about $42,000. This insurance has been approximately 4 per cent of our total sales during that period and is equal to 19 per cent of our sales at ages 25–29, the ages at which most of the sales under our premium financing plan are made. However, as with most innovations, the use of this plan has shown some tendency to decrease since it was introduced. Thus in 1962 the sales on this plan were equal to 23 per cent of our sales at ages 25–29, but this percentage decreased to 20 per cent in 1963 and to 16 per cent in 1964.

As might be expected, this financing plan is used a great deal by some agents and is used little or not at all by most agents. Twenty of our approximately 70 agencies have never sold a case on this plan. We have had approximately 1,800 different full-time agents during this period. Of these, only about 185 or one-tenth have ever sold a case on this plan; over two-fifths of this latter group never sold more than one case.

At the other extreme, one agent has sold 79 cases and another has sold 62 cases. During the entire period of a little over three years, 12 agents have sold 15 or more cases (or an average of about 5 or more per year), and of these 12 agents, 5 have sold 30 or more cases (an average of about 10 or more per year). These 12 agents alone accounted for about 45 per cent of the cases on this financing plan.

We have not been doing this type of financing long enough to have any significant experience on the persistency after the financing ceases. However, rough calculations indicate that the persistency during the financing period has been very satisfactory. The lapses during the financing period seem to have been about three-fifths of those which might have been expected for this age group. Because premiums under this plan are paid yearly and the interest is paid half-yearly, and because lapse rates for policies with yearly or half-yearly premiums are usually lower than those for policies with quarterly or monthly premiums, lapse rates for this plan should be lower during the early years than the average for this age group.

MR. ALLEN L. MAYERSON: Over a period of several years, prior to 1961, the Michigan Insurance Department became aware of a growing number of inquiries and complaints in connection with coupon policies. At the same time, we heard that other states were looking into the question of whether or not coupon policies were being improperly sold by agents, misunderstood by purchasers, and whether they were contrary to the public interest.

The first state that took definitive action was Wisconsin. In May, 1962, the Wisconsin Insurance Department adopted some very lengthy and comprehensive rules, which effectively outlawed coupon policies, charter policies, profit-sharing policies and various others.

On October 19, 1962, the Michigan Insurance Department issued a bulletin which, in substance, prohibited the issuance of coupon policies but permitted the issuance of a life policy which includes a series of pure endowments, provided that the gross premium for the endowments is shown separately. It was our thought that compliance with this regulation would cut down materially the opportunities for misrepresentation.

Our bulletin defined a coupon policy as any policy which contains a series of coupons attractively displayed, often on colored paper. These coupons give the appearance of interest coupons that are usually attached to bonds. We went on to say these coupons are in the actuarial sense a series of pure endowments. In the practical sense they are merely a refund of premiums previously paid by the policyholder. Then we said because coupon policies are susceptible to misrepresentation and are often misunderstood by the purchasers, no coupon policy will be approved for use in the state of Michigan on and after November 1, 1962.

You notice that we only prohibited these coupon policies where there actually are coupons. We do allow the sale of policies with pure endowments provided, as I mentioned, that the gross premium for the series of pure endowments is shown separately on the face of the policy.

There are some states that have gone further, and we have quite a few people who think that we ought to go further. I understand that the state of Minnesota has recently banned not only coupon policies, but also any policy with a series of pure endowments.

I think a coupon policy is inherently misleading, because you have these nice little green things that people probably think of when they read about millionaires clipping bond coupons. A pure endowment contract is not inherently misleading, though it certainly can be misrepresented very easily.

One of the problems is to keep a pure endowment contract, particularly if it is on a participating basis, from being misrepresented. This is what we are trying to do administratively. We do read the sales literature that companies using this type of contract put out for their agents, and we try to see that the sales presentation is fair, complete, and truthful.

We have shown up, sometimes uninvited, at sales meetings of a new company which is proposing to use a policy with pure endowments; a representative of the insurance department will sit in the sales meeting and listen to the type of presentation that the agents are taught to use in selling these contracts. When we get a complaint alleging misrepresentation, we act on it as quickly and as vigorously as we can.

It is possible that we may have to restrict policies with a series of pure endowments to those issued on a nonparticipating basis. When you have a series of pure endowments and a participating clause in addition, you open the door to a lot of romancing by the agents, which is difficult to control.

The other thing that has been under consideration is to require that a pure endowment be paid on every premium, including the first. This, of course, is not the pattern. Most companies issue a policy with a series of pure endowments and start the pure endowments in the second year. Some people think that if we require that a pure endowment be paid the first year, if it is to be paid at all, this would be one way of solving the problem.

MR. WILL R. MULLENS: Business Men's Assurance Company does not write a coupon policy and does not intend to do so. I therefore approach the problem with a completely open mind—or perhaps a completely closed one—depending on your point of view.

I have interpreted the term coupon policies as including policies using the alternate approach of annual pure endowments and have examined a number of such policies which are now being sold in some volume. A typical policy with coupons or annual pure endowments might have the following characteristics:

1. The basic coverage is whole life with premiums payable to perhaps age 80. The amount of the basic coverage may change with duration.
2. All premiums are returned at death if death occurs during the first 20 years.
3. An immediate draft death benefit in addition to the face amount is payable if death occurs before age 65.
4. Annual pure endowments start on the second policy anniversary and continue through the twentieth policy anniversary. The endowment is contingent on payment of the full premium for the policy year, and no allowance is made for termination off anniversary.
5. The policy is participating and may in some cases specify the sources and percentages of earnings which will be distributed as dividends.

It does not appear that coupons occur in modern policies, except as a part of a contract having several of the above characteristics. Perhaps for that reason coupons have suffered by virtue of the misrepresentation to which such policies are considered to be subject. For the purpose of the question under discussion, I will separate the coupon policy from the specialty policy and consider the coupon policy on its own merits.

With due apology to the framers of the question, the term "actuarial justification" is subject to as many interpretations as "actuarial soundness." Basically, we want to know if the customer gets what he pays for in a coupon policy. My answer is that if he does not, it is not the fault of the coupon concept but rather the fault of design and pricing. The coupon feature is simply a series of pure endowments for which a premium is charged as for any other feature of the policy. It can be, if anything, more straightforward and more clearly defined than the dividend in a participating policy.

In their paper, "The Regulation of Specialty Policies in Life Insurance" (*Michigan Law Review*, December, 1963) Kimball and Hanson state:

> One must conclude, unless there are arguments which are not apparent, that there is nothing in the nature of the coupon policy that makes it unsuitable as a commodity readily available in the market, provided only that it is not put into the hands of people who are in need of something else [p. 231].

They further comment:

> Whether or not it is concluded that coupon policies should be prohibited, or permitted only with full disclosure of the cost information that would make comparison possible, there is enough danger of misrepresentation and misunderstanding to justify additional effort in policing the marketing process. . . . It would require no new legislation, for every state seems already to have a statute broad enough to meet the need . . . [p. 247].

Based on the coupon policies I have examined, I would agree with Clarence Tookey, whose comments on coupon policies were reported in the October 17, 1964, *National Underwriter*, that a respectable coupon policy should have somewhat different characteristics than some now being offered:

1. The date the coupon becomes payable should be clearly stated and should be the same whether premiums are paid annually or in installments.
2. On default in payment of premiums, coupons and accumulations should be added to the cash value and to the amount of insurance under a nonforfeiture option.
3. On an off anniversary termination, if part of a premium is paid, part of a coupon should be credited.
4. Although Mr. Tookey does not mention this one, it has frequently been suggested by others: The cost of the coupon feature should be stated separately in the policy.

Although no exhaustive study has been made to our knowledge, we are inclined to believe that no new legislation would be required for implementation of the above requirements.

One problem of coupon policies which has not yet been mentioned is presently receiving the attention of the NAIC Subcommittee on Reserves and Non-Forfeiture Values and Related Matters of Coupon and Similar Policies. At the June, 1964, meeting of the NAIC, the subcommittee received the report of its Industry Advisory Committee and decided that the recommendations be presented to the association at its December meeting for action. In brief, the Advisory Committee's findings with respect to coupon policies were as follows:

1. The Committee regarded as of primary importance the tendency of some companies to use coupon policies primarily for the purpose of obtaining the large first-year expense allowances that result from liberal interpretations of the Standard Valuation Law as applied to such policies.
2. The Committee believed that the currently accepted interpretations produce first-year expense allowances which fall short of meeting the fundamental principle of reasonableness. It made specific recommendations which would serve to reduce the first-year expense allowance.
3. The Committee concluded that the insurance supervisory officials can implement its recommendations without additional legislation.

At the December, 1964, meeting of the NAIC, the subcommittee reported to the Life Insurance Committee that a unanimous decision could not be reached at that time. Perhaps someone in attendance here has further information on the current status of the committee's deliberations.

In summary, I conclude that coupon policies are not necessarily actuarially unjust but that some additional regulation is needed. Apparently no additional legislation is needed.

MR. FREDERICK S. TOWNSEND: Coupon policies have been marketed by new life insurance companies because supplementary benefits can be made a part of the contract and thus give the company a unique policy, unlike competition, which may be sold to the public and yield a reasonable profit to the company without incurring the huge surplus strains caused by engaging in loss-leader competition. The second reason, and perhaps foremost reason, why life insurance companies offer a coupon policy is that it is a great inducement in building an agency force. While the life insurance industry over the past few years has been mounting an ever increasing battle to come out with gross premium rates which are lower than competition, while maintaining a level commission scale, it has been the agent's paycheck which has been suffering. When an agent has an opportunity to sell for a company which offers a premium rate of $70 per thousand at age 35 instead of $19 per thousand at age 35 for a whole life contract, all he can envision is his first-year commission rate multiplied by $70 instead of $19. Although the agent will probably sell very few coupon policies as opposed to whole life policies, the fact remains that he is attracted to this new life insurance company by the lure of higher aggregate dollar commissions and is an enthusiastic producer.

There are three characteristics of coupon policies which might suggest special controls over their sales. First, I am strongly opposed to the sale of any policy which charges a ridiculously exorbitant premium rate. I am referring to those life insurance companies which have shown operating profits in their second and third years of operation and whose increase in aggregate reserve runs about 20 per cent of total premium income. Second, I am opposed to those groups of coupon policies which contain supplemental benefits that fulfill no particular insurance need. Third, I am opposed to the sale of coupon policies in those circumstances where such policies are marketed in conjunction with misleading advertising material.

MR. LLOYD K. FRIEDMAN: The rate is a matter of policy pricing, which can apply to any policy participating or nonparticipating. You could leave the coupons out completely and overprice the product, and perhaps the dividends would reflect the return.

With respect to the question of insurance need, it seems to me that this is a question for the policyholder to decide, and many innovations in our industry might have well been stopped if we had undertaken, or the insurance departments had undertaken, to decide what the policyholder needs instead of what he wants.

As far as the advertising material is concerned, I quite agree that it should be regulated. The evils that are complained of here are not evils in the policy form. They are evils of the sales methods, and these can be extended to regular participating insurance.

I had occasion a couple of years ago to run on the case of a large, old, eastern mutual company, which showed dividend projections on a life issued at age thirty-nine reaching up to age ninety. This seems to me to be gilding the lily just about as much as the sales material that comes out with some of the coupon policies.

Finally, I would like to raise the question of showing a gross premium for the coupon benefit. I have been asked to do this on occasion by insurance departments, and I frankly am at a loss how to do so. Four possibilities occur to me:

1. The net level premium equivalent to the coupon benefits calculated on the reserve basis.
2. The net level premium for the sum of (*a*) the coupon benefits and (*b*) the excess of the expense released for valuation purposes over that for the policy without the coupon benefits, calculated on the reserve basis of the policy.
3. The difference between the gross premiums including and excluding coupons calculated by the method used in calculating gross premiums for the policy,

yielding the same amount per thousand of insurance as margin for contingencies and profit.

4. The difference between the gross premiums including and excluding coupons calculated by the method used in calculating gross premiums for the policy, yielding the same percentage of premium as margin for contingencies and profit.

I hope members of the Society will choose among these methods or suggest a better one.

A. How long after the installation of a computer do savings in staff begin to appear?
B. Over what period is the cost of a computer amortized in determining costs?

MR. GENE P. ARCHER: The American Hospital and Life Insurance Company began to benefit from a reduction in staff even before installation of our computer system. In my opinion, this was the result of the work studies that were made by our systems research staff.

We went on the computer in September, 1964, with a 1401 tape system using a consolidated functions approach and looking at each of 56,000 master records daily. Six months later our staff consisted of 120 employees compared with 136 at the time of our feasibility study in 1961. We anticipate an ultimate staff of approximately 100 by two years after installation.

Our decision to develop a computer system was approved by our board on the basis that it would show an economic profit by the end of ten years. Our study indicated we should recover our installation expenses three years after we went on the computer system, and it appears this will be correct.

MR. JOSEPH R. PICKERING: A company should not view this equipment simply as a gigantic desk calculator if savings are to be realized. It pays off in the area of processing our tremendous amount of data and in providing better products for our customers.

I am bothered about the implication that the sole purpose of installing a computer system is to have savings in staff. It does cut down on staff in certain areas—notably in the large volume record-keeping area—but part of this savings is absorbed in other areas—notably programming and preparing input data for the system.

Another factor which confuses this staff savings question is that it is much more difficult to make changes than it was in the old manual systems. All your questions must be resolved before you make a change rather than working them out as you go along.

Another problem is evaluating the value of producing information which couldn't be produced before. Also, how do you evaluate the advantage of being able to produce a great deal of work with tighter deadlines than was possible before?

There is no simple answer. Probably the most important factor is the attitude of top management. The real profit comes from being able to do a better job for our customers.

MR. J. CRAIG DAVIDSON: There are four stages of sophistication in use of a computer: (1) replacing just one manual or punched-card routine by one based on a computer; (2) repeating the first stage for several functions, thus building up a master file; (3) taking advantage of the master file to produce management information we couldn't obtain before; and (4) moving to mass storage allowing random (and immediate) access from terminals far and near.

In the first two stages we are not doing anything new, only in a different way. Let us say it takes one year to assemble, reassemble, and tune-up a stage (1) system. Your staff will almost certainly increase to a peak some time before the system starts and will reduce during its first year. Stage (2) will somewhat exaggerate the considerations for stage (1).

When you reach stage (3), you start doing things which were economically impossible without a computer and a well-tested master file. It is exceedingly difficult to assess the validity and worth of figures such as comprehensive management information on production and expenses. I think it is absolutely vital, however, that the attempt be made to put a value on such computer output.

In computing, staff is a major expense, but the caliber of staff per dollar of remuneration will almost certainly improve with the introduction of a computer. It will probably also attract bright young graduates who would not otherwise give us more than a passing thought.

In regard to part B, the Canadian government permits amortization of the cost of a purchased computer in five years. Under New York law any such piece of equipment costing more than $100,000 can be amortized in not more than ten years.

MISCELLANEOUS

A. To what extent have functional cost studies been developed in the smaller companies? What uses have been made of the results?

B. To what extent, if any, have smaller companies adopted the year of investment method of allocating net investment income to line of business? What problems have arisen?

MR. DELOS H. CHRISTIAN: One needs only to compare total expenses to premium income to see the importance of this topic. This is especially timely in today's competitive market. In fact, astute management of expenses may be the key to survival for many of the smaller companies.

The purpose of functional analysis is to provide a basis for:

1. Actuarial calculations of asset shares, premiums, etc.
2. Study of competitive position on expenses.
3. Study of historical trends within the company.
4. Projection of costs on possible procedural changes.

For the first purpose, functional analysis is too detailed, since many assumptions of future experience are open to wide fluctuation. Therefore, at The Life Insurance Company of Virginia, we have taken a broader view and used just unit costs per policy and per thousand. We look for the most reasonable assumptions which will produce competitive rates.

For the last three purposes, we need consistent rules for allocating expenses. Therefore we have adopted the cost analysis system developed by the Life Office Management Association. More than thirty companies, including my company, contribute to these studies. Specific functions can be compared to highlight areas of possible improvement. By weighting the costs of the various functions, we can get an over-all comparison. The same figures within the company over a number of years give useful historical trends. These functional costs are also valuable for spotting opportunities to utilize computers and other cost-reduction procedures and for verifying savings.

In spite of uniform rules, however, there are different interpretations of expense allocation. The smaller the company, the more significant this becomes, since one person may be performing several functions.

One function that is particularly important to a small company is selection, training, and financing of new agents. This is really an investment instead of an expense.

MR. KENNETH F. FELDMANN: The Home Life Insurance Company has maintained a detailed cost-accounting analysis of home-office expenses since 1933 by which the various disbursement items are allocated on a functional basis by line of business and between first year and renewal. The analysis consists of 43 functions.

During any year most items of expense are cost accounted as they are incurred by means of a cost-accounting code. Certain expenses cannot be classified properly by cost accounting as they are incurred. Of these, salaries are the most important, since they constitute about half the home-office expenses and because the functional relationships of salaries are used in allocating many other expenses. The allocation of salaries is based on individual or departmental records of time devoted to each function.

The allocation of other home-office expenses not directly allocated is similarly based on detailed studies.

A broader functional classification is maintained for expenses incurred in the field, since such activities are scattered in so many different locations. Field expenses are maintained in the home office on a ledger basis and allocated to functions on the basis of studies made every few years.

It is easier to allocate expenses classified by function to line of business and between first year and renewal than when classified by the annual statement disbursement items. In addition, functional expenses are used to develop unit costs, which are used in the calculation of premiums, dividends, and asset shares, as well as for expense or budget control.

MR. FREDERICK W. CLARK: Lincoln National Life Insurance Company of New York has reached the point where we must think in terms of the point at which we are going to bring our outgo and our income into balance. I don't see how we can do that without a complete budget of expenses and a complete forecast making use of the budget and also taking account of annual projections of agency development expenses and production carried through to the income statement as a means of guiding our entire company development from this point on.

MR. GUY W. PICKERING, JR.: When transferring over to a computer basis, one has the problem of duplication of expenses, i.e., duplicate staffs in the interim. This makes it extremely difficult to get a continuity of comparisons from one year to the next. In addition, you can only half guess what the future savings will be. So there is a question whether you should take such savings into account in computing premiums and dividends.

MR. RONALD P. GIESINGER: I would like to describe briefly Great-West Life's adaptation of the method as it applies to Group Annuity business. The method is as follows. A calendar year fund is established each year consisting of the following:

1. Gross premiums received less actual benefit payments and expenses incurred during the calendar year.
2. Interest earned on all calendar year funds in the previous year.
3. Funds becoming available for reinvestment during the current calendar year. This is established using the average period over which funds have been found to be reinvested. Interest is credited on the unreinvested balance in each calendar year fund at the rate of interest at which the funds were originally invested.

This method introduces an increased degree of equity into the allocation of investment income among our Group Annuity policyholders and has enhanced our competitive position. It is a relatively simple method to apply and for this reason may have application for a smaller company.