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INDIVIDUAL LIFE INSURANCE COST DISCLOSURE ISSUES

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The paper "An Extension of the NAIC System for Life Insurance Cost Comparisons" by C. L. Trowbridge will be presented at this session.

MR. JOHN K. BOOTH: Cost comparison and disclosure for individual life insurance has been discussed and debated for well over a decade. Why is it that there are still divergent views on a subject that has received so much extended attention? Certainly, it is not for lack of techniques or methods for comparing costs to the consumer. Over the years, actuaries, academicians and others have proposed, analyzed, compared, studied, discarded, and reintroduced a variety of approaches to cost comparison. Nor is it for lack of public debate on the subject inasmuch as it has been discussed in many hearings before the National Association of Insurance Commissioners (NAIC), state insurance departments, committees of state legislatures and committees of the U.S. Congress. If the solution to the cost comparison and disclosure issue was merely one of finding the right method or technique for providing consumers with information to help compare policy costs, it would have been resolved long ago. What makes the issue so difficult is that it directly impacts the ability of rival life insurance marketing forces to compete for the consumers' dollar.

For a cost comparison and disclosure system to be acceptable, it must be perceived as not giving an unfair marketing advantage to any particular segment of the life insurance industry. If the system fails to meet this test, those insurers who feel their products have been maligned by the

system will be quick to point out that such a system may lead unwary consumers to purchase less advantageous products issued by their competitors. However, the goal of comparing costs in a way that fairly balances the advantages and disadvantages of competing life insurance products is an elusive one. Changes in the economy, the introduction of new products, increased replacement activity and campaigns of competing marketing groups to stress the advantages of their particular products make it difficult to find and maintain that essential pivotal point of balance upon which a successful cost comparison method must rest. Today we will examine where our ten years of discussion of the cost comparison and disclosure issue has taken us, how new products, marketing activity and replacements have affected the issue and what factors might be considered in achieving a fair and balanced cost comparison method.

MR. NORMAN K. MARTIN: It is difficult to talk of a subject such as the one we are addressing today without a brief perspective on where the subject has come from and what has been happening to it. For this reason, I would like to give a brief history of this issue. It should become evident that the pace of development has quickened in the recent past -- quickened and then died, or, maybe it has been lost in action. Actually, in giving you a recent history you will hear the entire history since the genesis of this subject is quite recent.

When an issue begins is sometimes difficult to discern. This particular issue may be traced to an address to the American Life Convention Annual Meeting in 1968. The late Senator Hart advised the insurance industry that it should improve cost disclosure. Senator Hart had become somewhat frustrated when the Veterans Administration had told him that they could not advise veterans as to which policies might be attractively priced for conversion of GI insurance.

The industry responded to this challenge in fairly fast order. The American Life Convention joined with the Institute of Life Insurance and the Life Insurance Association of America in establishing a joint special committee. This committee brought out a report in 1970 that started us down the path to disclosure. They found that the traditional net cost comparison was flawed and recommended that, for disclosure purposes, the 20th year interest-adjusted surrender cost index was a preferable method.

Working with the special committee's report, the NAIC brought out the model solicitation regulation in 1973. This model regulation required that interest-adjusted surrender costs and premium outlay indexes be furnished at the 10th and 20th durations. Note that the number of figures had by now been increased from one to four! The interest rate to be used in the calculations was 4%. There were other figures required in addition to the interest-adjusted figures -- premiums, values, dividends, etc. Not only were the foregoing figures required, it was also necessary to furnish a Buyer's Guide which was a simplified one chapter text book intended to educate the buying public with types of life insurance, types of companies, etc.

In 1974 the Society of Actuaries received a report which was prepared by the Society of Actuaries Committee on Cost Comparison Methods and Related Issues (Special). This study had been requested by the NAIC. The challenge seemed to be quite ably met -- that is, various formulae were

compared in an algebraic sense and a data bank of actual figures was used to determine what effect, if any, there would be on the relative competitive ranking between companies when different methods and different parameters were used. As any technician would expect, different methods did alter the relativity and rankings between companies. My interpretation of the results was that though there were admitted alterations in the rankings, the relative position of the various companies' figures included in the study did not change significantly. Another way of saying this, perhaps, is that, regardless of method, a good policy is a good policy and a bad policy is a bad policy.

In 1976, the NAIC revised the model solicitation regulation. Two more figures were introduced -- the 10th and 20th year equivalent level dividends. The number of figures was now up to 6! In addition, the interest rate to be used in the calculation was raised from 4% to 5% and the "premium outlay" terminology was changed to "net payment."

Before 1976 turned into 1977, the Federal Trade Commission (FTC) announced its forthcoming investigation into life insurance and its costs. In this announcement, the FTC anticipated that they would find a lack of competition in the marketplace. They also anticipated that perhaps a rate of return might be a better competitive and comparative tool than anything yet devised by the industry or the NAIC.

In 1978, Senator Moss' Subcommittee on Oversight and Investigation held hearings on life insurance. Their subsequent report suggested that a Linton Yield, a company retention index and a yardstick for comparative purposes would be helpful. They also commented on the FTC activity saying it had been lawful but not "diplomatic."

The actual FTC staff report was released in 1979. This report created a few waves -- and a good many headlines. Also, true to their anticipated results, the NAIC method was deemed not adequate -- a rate of return should be required and, surprisingly, there was no competition in the life insurance marketplace.

The Senate Committee on Commerce, Finance and Transportation under Senator Cannon was the official body to hear responses to the FTC staff reports. As is too typically the case, the sensationalism accorded the release of the FTC staff report was not duplicated by the hearings held by Senator Cannon.

Needless to say, the activity at the NAIC level increased. Hearings were held by the NAIC task forces in November 1979, April 1980, August 1980 and November 1980.

It should be obvious who the catalysts are who have triggered much of the activity on cost disclosure. Obviously, we have the federal level of involvement as personified by Senator Hart and the FTC. Within the industry, there are the American Council of Life Insurance (ACLI), the National Association of Life Underwriters (NALU), the Society of Actuaries (SOA) and the American Academy of Actuaries (AAA). Perhaps not an evident part of the drama to this point, we also have the representatives of academia. As representative of this group I would cite two of the more vocal -- Mr. Belth and Mr. Scheel from Indiana and Connecticut, respectively. The approach taken by these people is an approach that might

be anticipated — that is, if a little information is good a lot of information must be better. I am not too sure that practicality plays a part in their thinking. As of this time, there are no positions known to have been taken by consumer groups. It seems to me that consumerists such as Belth and Scheel do not necessarily represent consumers.

With all the recent activity that has taken place, what is the current status of the existing NAIC model bill? As of now, 36 states currently have adopted it. I believe 3 other states have held hearings on this subject but have not promulgated any regulation. The remaining states may not have sufficient interest in the subject to take a position.

The FTC staff report contained a model bill. The FTC model was introduced at the state level in more than one state and hearings were held. Prior to the release of the FTC staff report, representatives of the FTC had appeared at several hearings pleading that the states not adopt the NAIC model since they, the FTC, would undoubtedly come up with a better model. Even though they had nothing to offer at the time, their tactics did interfere with the adoption procedure. After their model became extant, it was introduced as an alternative at subsequent hearings. To date, the FTC model has not been adopted and is not in use in any state.

There continues to be pressure on the cost disclosure issue. So far as the industry is concerned, the 1976 NAIC model is supported by two important groups — the NALU and the ACLI. I believe it is fair to say the NALU was reluctant to give support at first but, considering the variety of alternatives and a perceived need for a degree of uniformity, they now support the NAIC model.

So far as professional groups are concerned, no official position has been expressed. The Academy of Actuaries has attempted to respond to a lingering criticism concerning a lack of equity between policies within a given company. They have proffered their technical assistance to the NAIC task force in the event that research as to differences in methods and results is desired. They also have a committee on dividend principles and practices. This committee acknowledges the existence of a wide range of dividend practices. They are attempting to put parameters on the comparability of dividends between policies and companies. They are also addressing the issue of the relationship between those dividends illustrated and those actually paid.

Within academia, there is continuing criticism of the NAIC model. There is also continuing insistence on a much larger array of figures. It seems to be the prevailing feeling that a large array of figures would be beneficial to the consumer and would tend to discourage malicious manipulation in life insurance pricing. Perhaps as distressing as the large array of figures and indexes that would be required is academia's desire for comparative figures not only at issue but after issue as well. Periodically, a policyholder would need to be shown not only the current dividend but also what that particular duration's dividend would have been according to the illustration at the time the policy was issued. Their feeling seems to be that this latter practice would discourage companies from exhibiting overly optimistic scales or from not living up to their illustrations. Perhaps that would be the case. I can think of potential dire consequences — particularly in the economic climate we have been experiencing -- when such

revelation could be detrimental by the potential impairment of a company's financial position when they do not reduce the dividends as early as they should because of external pressures.

The focus of all the debate on cost disclosure is, obviously, at the regulatory or NAIC level. As indicated, the NAIC has been quite active in the last year. The task force from the NAIC has had -- and continues to have -- advisory groups studying the questions of manipulation, lapsation, and the effectiveness of the current regulation. These groups have appeared before the NAIC task force on several occasions with interim reports. The first final report from these advisory groups is scheduled to be delivered -- with a recommendation -- to the NAIC in June of this year.

In the meantime, and with only interim reports from their study groups, the NAIC task force exposed a "new and unique" proposal. The schedule of development indicates that this new and unique proposal was drafted at an executive session in October of 1980. The first exposure to the industry was dated November 5, 1980.

Subsequent to that exposure, hearings were held in the same month as the initial exposure -- November 1980. The task force then presented this proposal at the NAIC December 1980 meeting. Fortunately, it was not presented for adoption. Obviously, in the relatively short exposure time there was no time to explore the ramifications of some of the significant departures from the current NAIC model. The impetus for the "new and unique" proposal can probably be traced to the continued criticism of the NAIC model by academia and to the effect of the FTC staff report.

Without dwelling at length on the "new and unique" approach that the NAIC task force espoused, I would like to mention some of the elements. First of all, their proposed method incorporates some new and, at the time it was proposed, untested measures. These measures were labeled "Probable Cost Index" and "Probable Annual Cost." I doubt that the personnel or the facilities necessary to test the new measures were in existence at the executive drafting sessions so the measures could not have been tested to any great extent. In addition, although one of the criticisms of the existing NAIC model was that too many figures were shown, the suggested revision had many more figures and many contiguous durations -- in fact, for each of the first 30 years there were about 9 columns of figures. Some of the columns involved the yearly rate of return, the probable annual cost, and a company retention type of figure.

The NAIC task force continues to function, but there has been a new chairman appointed. In the interim, some are taking advantage of the exposure time to examine and test the previously untested measures. The NAIC task force did meet in executive session at the end of February and presumably has met or will meet again. I would trust that there will be further public debate and hearings on the proposal -- but the ball is currently in the hands of the NAIC task force.

It should be evident from the foregoing remarks that the subject of cost disclosure is not a dead issue. The current system, while in existence in 36 states, is subject to change -- that change could be either minor or major. The opportunity and vehicles do exist to effect these changes.

What are the responsibilities of the various interested groups in attempting to get changes? Perhaps the first of these groups to be looked at involves the professional organizations — the SOA, AAA, NALU, etc. These particular groups need to study the various proposals as to their technical accuracy. A comparison of results achieved is one way to assess which of two methods — one simpler than another or more understandable than another — is preferable if the results are quite comparable. What about the usefulness to the consumer? Obviously, a system which will not be used by the consumer is of little benefit to that consumer. Because of the expense of instituting any system, it is not practical to adopt a system, compel its use and then discard it if it is not effective. The results of technical research can assist the regulators in their quest for a system. It is preferable to have uniformity between the various jurisdictions. Any requirements of calculations beyond those ordinarily done for a given policy are going to require considerable time and effort — both ingredients varying directly with the complexity of the calculations. So far as trade associations are concerned, their obvious responsibility is to ascertain the majority position of their membership. Their job would certainly be easier if a consensus of their membership could be gained. The current NAIC model is the result of accommodation between representatives of participating, non-participating, small and large companies, as well as operators in different markets — a blended position. An association has the responsibility of making the regulators aware of the position adopted by their members and the rationale behind that position. Creating this awareness can be through testimony — both oral and written — on behalf of the membership or through asking their members to go on record individually in support of the position.

Individual companies can and do pursue independent courses on these subjects. It would be most desirable for these companies to incorporate in their thinking the eventual result of whatever system they are propounding — hopefully no company would pursue a system devised to give a temporary advantage when the foreseeable result in the foreseeable future is chaos.

So far as influencing the eventual outcome is concerned, the NAIC can be approached concerning their model regulation and revisions, if any, to be made in that regulation. At the state level, the insurance departments would appreciate knowing how various individual parties think on this subject. Most departments might even appreciate some technical help. Above all, the departments need to have some appreciation of the practical aspects — the usefulness of a system to the consumer.

I would admit to tempering these remarks with practicality — but I think that is important. I would urge everyone to take the problem of cost disclosure seriously. If you have not had an opportunity to become acquainted with what exists, what has been proposed, etc., perhaps you should make an effort to find out. I can assure you that the potential for added costs to the company and the consumer is very real.

MR. WILLIAM T. TOZER: I will make a few comments about cost disclosure for various products. These comments will be only suggestions and are not adopted policy by anyone. My comments are based on the assumption that the interest-adjusted method or a modification of this method will be used in the future. I plan to conclude my remarks with some comments about replacements.

The current cost disclosure regulations contain an element known as the Equivalent Level Annual Dividend. The Equivalent Level Annual Dividend is used to give the public an indication of the portion of the index that is not guaranteed. Up until recently, this has been a satisfactory approach since dividends were essentially the only non-guaranteed element in the marketplace. This is no longer true and the Equivalent Level Annual Dividend needs to be replaced by a non-guaranteed element. The Non-Guaranteed Element would be the difference between the cost index on the highest possible cost basis and the cost index on the currently illustrated non-guaranteed basis. For most plans, the Non-Guaranteed Element for the surrender cost index and the payment cost index would be the same. However, this is not always true. When the elements are not the same, a separate element should be calculated for each cost index. Suggestive modifications of cost indexes for various products are as follows:

1. Traditional participating product: For this product, I would first calculate a surrender cost index taking into consideration premiums, benefits, cash values, annual dividends and any terminal dividends. Next, I would calculate a surrender cost index ignoring all dividends. The difference between these two indexes is the Non-Guaranteed Element. Next, I would calculate a payment cost index including annual dividends but excluding any terminal dividends. Also, a payment cost index would be calculated ignoring all dividends. The difference between these two payment indexes would be the Non-Guaranteed Element of the payment cost index. As a result, the Non-Guaranteed Element of these two indexes may not be identical since the surrender cost index uses terminal dividends and the payment cost index does not.

This approach differs from the current cost disclosure regulation. It would use terminal dividends in the calculation of the surrender cost index. The current cost disclosure regulation does not.

2. Non par adjustable premium whole life product: This is a whole life product with a fixed death benefit which has a set of maximum guaranteed premiums but provides that the premiums to be actually charged may be less and may be redetermined from time to time by the insurer based on the then current projected assumptions. Under this product, I would calculate surrender cost indexes using the current projected premium scale and the maximum guaranteed premium scale. The difference between these two cost indexes would be the Non-Guaranteed Element. Payment cost indexes would be calculated on a similar basis. If this product is offered on a participating basis, the above calculations would have to be adjusted for annual and terminal dividends where appropriate.

This approach assumes that current projected assumptions will occur in the future. However, the approach discloses in the Non-Guaranteed Element the effect these future projections have on the indexes.

3. Non par single premium adjustable benefit policy: This is a single premium whole life product that provides that the insurer may increase or decrease the cash values or death benefits or both in the future based on then current projected assumptions. However, the cash values and death benefits may not be reduced below a guaranteed minimum.

For this product, a surrender cost index would be calculated using the current projected benefit scale and current projected cash values. Also, a surrender cost index would be calculated based on the minimum guaranteed death benefit scale and the minimum guaranteed cash values. The difference in these two surrender cost indexes would be the Non-Guaranteed Element. Similar payment cost indexes would be calculated. If the product is participating, the calculations would have to be adjusted accordingly.

Again, the Non-Guaranteed Element discloses the effect of current projections.

4. Enhanced ordinary life policy: I am confining my comments to a participating policy which has the following characteristics for all issue ages:

1. A guaranteed death benefit that reduces after an initial period to a basic amount, and
2. A special dividend option that provides a combination of immediate paid-up additions and one year term insurance, or deferred paid-up additions, that on the basis of the current dividend scale will provide a combined death benefit at least equal to the policy's initial face amount.

I would first determine a "cross over" point. This would be the first policy anniversary where the reduced basic death benefit and paid-up additions equal or exceed the initial death benefit.

In calculating cost indexes before the "cross over" point, I would assume that annual dividends are used to maintain a level death benefit equal to the initial death benefit. After the "cross over" point, I would assume dividends are used to reduce premiums.

I have assumed that dividends after the "cross over" point are used to reduce premiums because (1) this approach produces an essentially level death benefit for the life of the policy — the basis on which the policy is usually purchased, and (2) this approach reduces the temptation to manipulate enhanced ordinary life policies. With this approach, premiums are not reduced by annual dividends before the "cross over" point. Instead, the death benefits and cash values are raised.

When the enhanced ordinary life uses deferred paid-up additions, this plan would have a non-level death benefit. The indexes would be calculated accordingly.

5. Revertible term policy: This type of term policy contains all of the normal features of a renewable term contract. In addition, it has a feature that permits the insured to renew the policy at a lower renewal rate if he submits satisfactory evidence of insurability.

The obvious problem with this type of policy is determining what future premiums should be included in the indexes. I would calculate two sets of cost indexes. The first set would be based upon the assumption that the insured always qualifies for the lowest possible premium. The second set

would be based on the assumption that premiums are charged at the highest possible level.

On each basis, disclosure of the Non-Guaranteed Element, if any, would be required. Also, a clear explanation of the requirements for the lower renewal premiums would be given.

I would use this approach because (1) the cost is not completely under the company's control, and (2) the cost can be affected by changes in the insured's health or the company's underwriting standards.

6. Multi-track plans: These policies allow the insured the option to increase or decrease the amount of insurance and to change or convert the plan of insurance.

For these plans, I would calculate cost indexes based upon the assumption that the automatic option is exercised. However, I might make additional displays of cost indexes on other options provided I stated the assumptions that pertain to the exercise of the options.

7. Term and annuity combinations: Term and annuity coverages may be provided by separate contracts or a base policy and a rider. Dropping or changing one coverage may or may not affect the other.

With these programs, I would use the Life Insurance Solicitation Regulation for the term part and the Annuity and Deposit Fund Disclosure Regulation for the annuity part.

8. Flexible life: This policy permits the policyholder to vary the amount of his premiums, the frequency of his premiums, and the amount of his death benefit.

With this policy, the policyholder pays a premium. From the premium, various expense charges are deducted. The remainder is added to the cash value that accrues at interest. Each month a mortality charge is deducted based on the net amount at risk, the attained age of the insured, and the mortality rate schedule.

For flexible life, I would first calculate a surrender cost index using the indicated initial annual premium as the annual premium for all renewal years. By indicated initial annual premium, I mean the initial premium unless the applicant states that the initial premium is a mode premium. In that case, I would annualize the indicated mode premium. I would use a level death benefit equal to the initial death benefit unless the contract requires a higher death benefit which would then be used. I would develop a cash value using the current expense loads, the current mortality rate schedule and a level current interest rate. If the contract were participating, dividends would also be considered. A second surrender cost index would be calculated using the same premiums. I would use the initial level death benefit, but if the contract required a higher benefit, I would increase the death benefit to the minimum required by the contract. I would develop the cash value using the maximum expense loads, the maximum guaranteed mortality rate schedule, and the minimum guaranteed interest rate schedule. Dividends would not be considered. The difference in these two indexes would be the Non-Guaranteed Element. The payment cost indexes

would be calculated by a comparable method. I would disclose under what conditions the expense loads, interest rate or mortality charge may be changed. I would also disclose when and how often the changes can be made.

This approach treats flexible life as a continuous level premium, level death benefit whole life policy. This is the type of program that most people think about when life insurance is discussed. Second, this approach emphasizes that the payments made by the applicant are the premiums — not the expense loads or monthly mortality charges.

Once each policy year, I would send the policyholder a report showing the premiums, expense charges, mortality charges, interest credits, current cash value and current interest rate. If the current cash value is not sufficient to provide a full death benefit to the next anniversary without the payment of an additional premium, the estimated date of lapse for non-payment of premium would be shown.

Historically, companies were reluctant to replace life insurance because they might be in violation of the "twisting" laws. Times have changed. In 1969, the National Association of Insurance Commissioners developed the 1970 Model Life Insurance Replacement Regulation. This removed most of the "twisting" fears. Later, a 1979 Model was adopted. Approximately 30% of the states have adopted the 1979 Model. The remaining states have adopted the 1970 Model or in the case of two states, a special regulation. My comments will be directed to the more current 1979 Regulation.

A life insurance replacement is any transaction in which new life insurance is to be purchased and the agent should know that existing insurance is to be:

- (a) Lapsed, surrendered or
- (b) Continued as reduced paid-up, extended term insurance or
- (c) Amended to reduce benefits or shorten the term of coverage or
- (d) Reissued for a reduced cash value or
- (e) Borrowed now or in the future for 25% or more of its loan value.

The Life Insurance Replacement Regulation excludes:

- (a) Annuities,
- (b) Credit insurance,
- (c) Group insurance,
- (d) Tax Qualified plans,
- (e) Variable life insurance,
- (f) Conversion with existing company, and
- (g) Non-Convertible, Non-Renewable Term insurance expiring in less than 5 years

The replacement regulation has several requirements. First, the application must have a statement from the applicant stating whether existing insurance is being replaced. The agent must also state whether replacement may be involved. If replacement is involved, a notice stating the hazards of replacement must be given the applicant. Two different notices are prescribed — one for replacing another company's policy and

one for replacing the same company's policy. The applicant must sign a copy of the notice stating that he received the notice and read it.

Second, the agent, before the application is signed, must complete a comparison form. One copy of the comparison must be signed by both the agent and applicant and sent to the replacing company. A copy of all sales material used in the presentation must be given to the applicant and another copy sent to the replacing company. The comparison form compares the existing insurance and new insurance in many areas, such as: contestable expiry date; suicide expiry date; maximum policy loan interest rate; premium amounts, premium paying period, benefit and benefit period for the basic policy, each rider, and each supplementary benefit; cash values and dividends for current year, 1 year hence, 5 years hence, 10 years hence and at age 65. In addition, the agent must state in writing why he proposes replacement, how he proposes the existing insurance be handled, and why the existing insurance does not meet the applicant's needs.

Third, the replacing company must verify the accuracy of the comparison form. If the form is not substantially correct, the agent must complete and sign and have the applicant sign a new substantially correct form before the company can begin in processing the application.

Fourth, the replacing company must give the applicant a cost disclosure. The Regulation includes the cost disclosure regulation in case a state does not already have a cost disclosure regulation.

Fifth, the replacing company must, within 3 working days after receiving a substantially correct comparison form, send a copy of the form to the existing company.

Sixth, the replacing company must give the applicant a 20 day "free look" and send the existing company a cost disclosure within 3 working days of policy issue or delay issue for 20 days after the cost disclosure is sent to the existing company.

Finally, the replacing company must maintain a file of all the material used with each replacement. In addition, a replacement register must be maintained, cross indexed by replacing agent, and existing company.

One of the major problems with the current Regulation is its exclusions. For example, many current replacements are term and annuity combinations. Annuities are excluded from the Regulation. This results in an incomplete comparison.

In 1980, an ACLI task force recommended a separate regulation to deal with life insurance and annuities. This regulation would be very similar to the 1979 Replacement Regulation but would include annuities. In addition, it would include as part of the Replacement Regulation both the Model Life Insurance Disclosure Regulation and the Model Annuity and Deposit Fund Disclosure Regulation. However, the recent uncertainty about the Life Insurance Cost Disclosure Regulation has made it very difficult to recommend any Annuity Replacement Regulation. At the request of the National Insurance Consumer Organization, the NAIC in December agreed to study annuity replacements.

Because of the significant increase in replacement activity, several states are strengthening the replacement requirements. For example, the Commonwealth of Kentucky enacted a replacement law. This law, in addition to the Model requirements, also requires the replacing company to delay issue of the policy until 30 days after all material is sent to the existing company. In addition, the policyholder must have an additional 30 days "free look" after issue. Also, the incontestable clause must be amended to take account of the period of time the existing policy has been in force. Thus, the new policy may actually be a guarantee issue case if the existing policy's incontestable period has expired.

There is currently a bill in the Tennessee Legislature that incorporates the Kentucky requirements. The bill also immediately vests the cash value of the replaced policy plus interest if the cash value is deposited with the new company or used to pay additional first year premiums. The interest rate cannot be less than the reserve valuation rate. Also, the cash value plus interest must be returned at any time upon written request of the insured.

It appears to me that we have not seen the end to the increasing number of replacements or replacement regulations.

MR. C.L. TROWBRIDGE: My interest in this challenging subject goes back to my membership on the 1970 Joint Special Committee chaired by Jack Moorhead. This Committee proposed what was then known as the interest-adjusted method, which later became the basis of the NAIC approach now in effect in some 2/3 of the states.

I was not chosen for this panel because of my long interest in this subject. I was chosen because I am the author of a paper entitled "An Extension of the NAIC System for Life Insurance Cost Comparisons." This paper is in no sense an attack on the current NAIC method. (It could hardly be so, in view of my signature on the 1970 document, unless my change of base from the insurance industry to academia has made me inconsistent with my former position. I note that Norm, when he read the names of a couple of academics, deliberately did not include my name although I am now a part of academia. I appreciate his doing so because I approach this problem not from an academic viewpoint but from a long term association with the same industry of which most of you are a part). I still believe that the interest-adjusted approach is as good as any, and much better than most, if the method is confined to comparisons between essentially similar policies.

The purpose of the paper is to make a suggestion which will make the NAIC method more general, by lifting the severe limitation that only similar policies be compared. Today there is considerable interest in comparing term with permanent, new policies with policies already in force and the many different forms of multi-track policies. For such comparisons the NAIC method is not theoretically sound, and has never been so represented. I consider this lack of generality the only important weakness of the NAIC method. But today it is almost a fatal weakness because, more often than not, the comparison one wants to make is not between similar policies. The paper takes the position that the NAIC method can be generalized to dissimilar policies by one rather simple modification. An interest-and mortality-adjusted index eliminates the theoretical weakness inherent in

the more familiar interest-adjusted index when end of period cash values are appreciably different (as they will always be if the policies compared are dissimilar, and are sometimes even if they are similar). This is not a new approach. In fact the interest-and mortality-adjusted index which I am proposing was studied by the 1974 Society of Actuaries committee along with other methods. They came to the conclusion that no method was good for comparing dissimilar policies. I guess in that sense I am disagreeing with them.

If I am right and if this simple modification would really compare dissimilar policies in a noncontroversial way, then all of the problems of life insurance cost comparison would seem to be solved. Unfortunately this is not the case because the method proposed involves two sensitivities not encountered before. The lesser of these is the mortality table assumed for the purpose of the comparison -- much the greater is the assumed interest rate. The paper shows that (1) term insurance and policy replacements show up relatively better under the method I propose when interest and/or mortality rates are assumed at a high level, and (2) permanent insurance and old policy preservation show better if low rates are assumed. Fairness to both term and permanent advocates, and to both replacers and preservers of existing insurance, requires some resolution of the question of an appropriate interest rate (and to a much lesser extent, an appropriate mortality assumption).

MR. E. J. MOORHEAD: A recent development in cost disclosure requirements is the Wisconsin Supreme Court decision prohibiting, by a 5-to-2 margin, the Insurance Commissioner from enforcing a proposed simplified preliminary disclosure arrangement. I believe this case brings up the following five matters important to actuaries:

1. Commissioner Mitchell is a type of regulator who, regardless of the merits of her argument in this particular case, actuaries should be glad to have in commissioner ranks.
2. It is often said that one of the advantages of state over Federal regulation is the opportunity afforded by the former to experiment on a relatively small scale with rules that may or may not prove to be effective.
3. The Wisconsin Commissioner has been prevented from experimenting with a cost disclosure plan that, by exhibiting at the outset the surrender cost index only--omitting the net payment index and the equivalent level annual dividend, might have assisted buyers in making wise choices among competing products.
4. The majority opinion of the Wisconsin Supreme Court contains statements that I believe do not stand up to close examination by knowledgeable actuaries whose own products are not at stake.
5. The victory of the companies and agents who took the Commissioner to court will turn out to be of the Pyrrhic variety, and one which eventually will be regretted even by the parties who achieved it.

Having said that the majority opinion will not stand up to critical analysis by actuaries I will mention just three points without suggesting that these are the only points. The first point is that if in a particular comparison the surrender cost index and the net payment index point in different directions I think the Supreme Court is clearly mistaken in indicating that buyers who rely on the surrender cost index would be seriously misled. My emphasis is on the word seriously. I think it can certainly be demonstrated that small differences will develop in some of the cases. Obviously, if the surrender cost index and the net payment index point in the same direction the matter is moot because regardless of which is used the same conclusion would be reached. The second point is the drawbacks to giving people, who really do not understand life insurance, a large array of figures to struggle with. But the third, and I think the most serious flaw in the Supreme Court's argument, is that a well advised buyer purchases a life insurance policy with the intention of keeping it in force until death occurs.

MR. BOOTH: Trow, since your paper contemplates a single index, how do you view this?

MR. TROWBRIDGE: My approach does contemplate a single index. What my approach really does is weigh between the net payment index, which might be an appropriate measure if the person dies, and the surrender cost index, which is probably the right measure if a person lives. It weighs between them in accordance with the mortality table. It avoids the argument that term insurance is obviously better if you die and permanent insurance is obviously cheaper if you live but you cannot compare the two unless you know whether you are going to live or die.

As to the equivalent level annual dividend, I suppose my method could contain it. I just do not have any particular opinion as to its importance.

My method would reduce the number of comparisons in half. In his discussion of my paper, Jack Moorhead says in effect that the NAIC's current approach requiring six numbers instead of one (or two if you use different durations) was a bad misrepresentation of what the original committee intended. He states that my method solves that problem by forcefully combining the indexes.

MR. BOOTH: An important question which deals with replacements is how do you compare a new policy with an existing policy. In the past year or so, the state of Vermont promulgated a regulation on cost disclosure, which is similar to the NAIC model, but it has a new wrinkle in that it does require a cost comparison index for existing policies. Basically the index is calculated in the same manner as the cost comparison index for a new policy except that the cash value of the existing policy is brought into the equation as an addition to the premium for the first year of the comparison period. Trow has a similar approach except that he has introduced a mortality element.

We have also seen a proposed regulation in the state of New Jersey which took a somewhat different approach. I believe Jim Hunt gave some testimony in Maine where he presented an approach to getting an index for an existing policy. Last October in the CLU Journal, Professor Harold Skipper of the University of Georgia presented an approach for getting a modified cost

comparison index for existing policies. Harold Ingraham of New England Life took the New Jersey approach, Jim Hunt's approach and Professor Harold Skipper's approach and demonstrated mathematically that they were the same method. They are not, however, the same as the Vermont method. The principal difference is that they follow the Vermont approach by including the existing cash value as an addition to the first premium, but instead of dividing that amount by the equivalent level face amount, as defined in the NAIC model and as used in the Vermont index, they divide by the equivalent level face amount less the initial cash value. Therefore, the index is calculated on a net amount at risk basis. Would anyone like to comment on either of these approaches for developing indexes for existing policies?

MR. ROBERT LIKINS: I have had an opportunity to look mathematically at the formulas that you have mentioned and I agree that the last three are the same. I think the explanation for deducting the initial cash value in the denominator of the three formulas is as follows: if you have a policy for \$1,000 and it is a few years old, and it now has a cash value of \$200, you could surrender that policy, put the \$200 in the bank and buy another whole life policy for \$800. Anytime thereafter (forgetting about tax on investment, etc.) both the person who kept the \$1,000 original policy or one who surrendered the policy and bought the new policy would have a death benefit of \$1,000.

If you had theoretical policies which were based only on five percent interest and the 1958 CSO mortality table, then the surrender cost index for the new \$800 policy is equal under the NAIC method and the three equivalent methods. In order to get the same index on the policy which is in force the cash value must be deducted in the denominator as the three methods suggested. It seems fairly clear that the theoretically correct way, if we could agree that getting equal indexes with theoretical policies gives a theoretically correct answer, is to deduct the initial cash value in the denominator. Of course, this gives a larger surrender index since the numerators of the Vermont index and the other three are the same.

MR. BOOTH: I worked through some of the mathematics on a pure net level premium basis and found that the sum of the original whole life premium at age x and the discount rate on the reserve at duration t will mathematically equal the attained age premium at $x + t$ for an amount of insurance equal to the net amount at risk on a theoretical policy.

MR. LIKINS: In my mind I think of the three formulas as a generalized version of the NAIC formula because they will reproduce NAIC results for new policies. It is also fairly easy to think of the Harold Skipper formula as a generalized formula for inforce as well as new policies. However, it is important to remember that the Harold Skipper formula, as he pointed out explicitly, does have the same limitations as the NAIC formulas. It should only be used to compare similar policies.

MR. TROWBRIDGE: As I pointed out in my paper, if net premiums are calculated on the same interest and mortality table that is going to be used to make the comparison, then the indexes for theoretical policies will be equal. One of these two approaches will produce the same index and one will not. Whichever one produces the same indexes for theoretical policies is right.

MR. DONALD MAIER: We have agreed that the numerators of the equations for the indexes are the same algebraically. The major difference is that you obtain an index in terms of the full amount of insurance in one case and an index in terms of the initial amount at risk in the others. The utility of the two might be viewed from the point of view of what kind of replacement you are dealing with. If you are dealing with a replacement where the whole existing policy is replaced with a new policy containing the same amount of insurance, then perhaps the Vermont method is more appropriate. If you are dealing with a replacement where the cash value is invested and only the net amount at risk is replaced, then the Harold Skipper method would seem to be a more sensible method.

The major problem with comparing dissimilar policies has always been the sensitivity to the interest rate. In a replacement situation you have a greater sensitivity because you are dealing with an existing cash value which may be quite substantial. What you decide to do with the cash value is very important. If you decide to place it in a savings bank at 5 1/2% interest you will obtain one result. If you place it in a money market fund at 14 or 15% you will obtain a different result. In any event the comparison of a replacement and a new policy will be greatly impacted by the interest rate chosen. I do not see how either of these formulas answers the interest sensitivity question.

In a comparison of term policies you would expect that when mortality is introduced the comparison would be considerably more sensitive to changes in the mortality than to changes in the interest rate. The work that I have done with Trow's method shows this is not so. Trow's method really treats the mortality as an additional discount and it is considerably less powerful than the interest rate assumption. The interest rate selection is still the most important factor in the dissimilar policy situation.

As to the prior discussions on the payment index, I do not think too highly of the index's importance. As a matter of fact whenever the payment index points in a different direction than the surrender index, especially when looking at a ten year index, you can look at the premium and be pointed in the same direction. So I am not so sure that it is a very important number. But I am not ready to give it up because I feel that the four indexes of the NAIC system can be shown to be useful in replacement situations.

MR. TROWBRIDGE: Whenever you compare dissimilar policies, you will get extreme sensitivity to the interest rate with any of these indexes. The value of the twentieth year cash value is partly sensitive to mortality and very sensitive to the interest rate. As soon as you raise the interest assumption a term insurance policy will be more favorable than a permanent insurance policy and a new policy will be more favorable than an old because a new policy has lower cash values.

MR. MAIER: I agree that the mortality assumption does not have a large effect on Trow's method. The real sensitivity to the mortality assumption is found when you examine some of the other methods, e.g. the Probable Cost Index, the rate of return or the company retention, (of which the PCI is a variant).

MR. SAMUEL TUCKER: As I recall, Milton Goldberg came out with a comparison index some years ago which he explained in the publication, "Probe".

His method calculated a level annual premium for each type of coverage being considered, that being the actuarial equivalent of the fluctuating premiums (gross premiums less dividends). The Equivalent Level Annual Premium (ELAP) was to be calculated on the basis of specific mortality and interest assumptions for the full duration of the plan (without anticipating surrender). A lump sum index was also contemplated.

In the original Goldberg article, he referred to "the Present Value Method identified as the 'Trowbridge Method' /which/ is actuarially sound, defining the basic price index as the present value at issue date, of premiums less any dividends, all the way to maturity of the policy, discounted for both interest and mortality, but not for withdrawal."

I was wondering whether the Goldberg method has some historical relevance to Mr. Trowbridge's method?

MR. TROWBRIDGE: I remember an earlier conversation with Mr. Goldberg about his method. I suspect what he was proposing was very close to what I am proposing. My recollection is that his equivalent level premium was calculated for the full duration of the plan as opposed to the end of ten or twenty years.

MR. JAMES HUNT: I think this discussion about the sensitivity of any of these methods to the interest rate assumption is a reflection of the fact that the interest rate is very important and possibly the rate of return is a technique of cost disclosure that ought not be cast aside.

Another point I would like to make, is that I find the interest-adjusted method of the NAIC to be actuarially dissatisfying since the restriction to similar policies is so severe. For those of you who do not understand what I am saying, I urge you to read my discussion of Mr. Trowbridge's paper.

Despite all of the activity that has been carried on over a couple of decades, I wonder whether the public is any better off under the current system than it was under the zero interest assumption of the early 60's. I think there is a good argument that it is more deceptive today to use 5% than it was to use 0% in the mid 60's. Replacements are a serious problem and I have the impression that many people are being hurt because there is no way of making comparisons among dissimilar policies, but everyone is making them. It used to be that agents were somewhat reluctant to engage in replacements, but now it seems that the agents of all the "best" companies do. We have not done enough to demonstrate the ways in which old policies can be retained to the advantage of policyholders. One of the problems that arises involves the policy loan question. If your friend asks you about his old policy and if you analyze it, you may say he would be making a mistake by replacing it. But he also might be making a mistake not to replace it if he is not going to borrow the cash value and reinvest it at higher rates. It makes all the difference in the world which assumption you use in giving advice. In giving advice to their own policyholders companies cannot, for obvious business reasons, suggest borrowing the cash values. But this leads me to ask those in positions dealing with replacement regulation activities to give some consideration

to the ludicrousness of calling a policy loan increase of more than 25% a replacement. Obviously the policy is not replaced and the policyholder is slightly better off. That activity should be encouraged at least on behalf of consumers who otherwise are going to be talked into replacing their old policies which are becoming increasingly valuable due to old policy loan privileges.

MR. DALE GUSTAFSON: I have two comments. First, I want to add my sincere praise for the very fine piece of work Trow has done. At first blush, it seems so simple, even trivial. But the more I have studied it, the more convinced I have become that it is not simple at all. It seems to be a simple adjustment to the interest-adjusted index. It is much more than that. It virtually transforms it into a new, much more powerful technique. I strongly urge all who are concerned about cost comparisons to study Trow's work, and the ongoing discussion of it, thoughtfully and carefully.

Second, I want to comment on one aspect of comparability. It will demonstrate that there is more to cost comparisons than merely the formula.

In my next remarks, when I use the term Universal Life, I am using it in the general sense, thus including any deliberate packaging of term and annuities or other investment vehicles whether contained in a unified contract or not.

Universal Life is in, Whole Life is out. Or so the Universal Life marketers are telling us. Universal Life is interesting in its own right, but I believe a large part of its current status is based on inappropriate and inadequate illustration techniques. Let me be specific with one aspect as an example.

The Universal Life products that I have seen are all based on (1) specific currently high yielding investments, or (2) new money, or (3) if portfolio, a newly established portfolio. The sales illustration then illustrates that high current interest rate for as many years as needed.

On the other hand, a Northwestern Mutual inforce ledger shows our current dividend scale which is based on our current portfolio rate. Thus, even though our new investments are also high yielding, our illustration in effect assumes that our new money rate drops immediately to our current portfolio rate.

If the assumption implicit in the Universal Life illustration is valid, then our portfolio rate will continue to increase and we will have the resources for substantial dividend scale increases. If the assumption implicit in our illustration is valid, then the universal life product will not earn the return illustrated for it.

The respective implicit investment return assumptions are inconsistent and render the illustrations incomparable.

I referred to our inforce ledger because the Universal Life products seem predominantly aimed at replacement; many of them quite openly and explicitly so. We have now seen the details of well over 500 Universal Life proposals for replacement of inforce Northwestern Mutual policies. I

mean replacement. They do not attack the mix to date, they propose to take that mix as is.

I would like to offer a challenge to the actuaries who are associated with a company issuing a form of Universal Life, unified or not. All of the ones I am familiar with have actuaries associated with them, including a couple of chief executives, a couple of marketing officers, several chief actuaries, of course, and in some cases, consulting actuaries.

I challenge you to say to me: "On a financial value basis, it is appropriate for your old policyholder to base his judgment on our respective illustrations without caveat or comment on the two investment return assumptions. Further, it is my considered opinion that in the long run, your old policyholder will more than likely be financially better served by terminating his present Northwestern policy and replacing it with my company's combination product." Note I have not used the following terms: Projection, nonparticipating, or participating in my remarks.

As an aside, I would observe that we have yet to see a Universal Life replacement proposal that stated our numbers right. "Oh, well", you might say, "that is understandable, current dividend information on inforce policies is hard to come by." Of course, you are right, but maybe you might expect a certain randomness in the errors? Wrong! In no case have they guessed our numbers favorably to us, always unfavorably. New money over portfolio is not enough, they have to lean on our numbers each time too.

MR. TOZER: Gus' comments are very pertinent. A very serious situation occurs when a new policy which uses a new money interest rate is compared with an existing plan which uses a portfolio rate. We must learn how to handle the situation properly for both the public and ourselves.

MR. OVERBERG: I want to report that both the American Academy's Committee on Dividend Philosophy and the NAIC's Committee on Manipulation are going to recommend at the June NAIC meeting that a statement be included in the disclosure documents given to a customer which would indicate whether an investment year or portfolio interest rate is being used.

MR. BOOTH: In view of Gus' remarks it would seem that the disclosure should be broader than just mentioning whether a portfolio or an investment year method is being used. There are other ways of getting a new money approach, e.g. starting a new company or a new portfolio. Do you think the scope of the statement should be broadened or is it anticipated that its application will be more general?

MR. OVERBERG: Under the Academy committee recommendation, the year in which the interest rate is starting must be indicated.

MR. BOOTH: If anyone at this concurrent session had the power to set an interest rate to be used in the NAIC cost disclosure index, what rate would you set and why?

MR. HUNT: Last fall, a task force for the NAIC deliberated this and suggested 8%. The theory which they used was that although the savings rate is 5%, the borrowing rate is much higher. In dealing with the public,

they felt that the difference should probably be split. I thought that was an interesting analysis and the interest rate might have been reasonable.

As I mentioned earlier, I feel that people are losing a lot of money in replacements and the insurance companies are not doing enough to stop it. I know at least one company which will offer a prospective rate of return on an existing policy according to the Linton Yield principles. It seems to me that a company could give two illustrations to its policyholders. One would be made according to its current dividend scale and the other would show a future rate of return on existing business if interest rates stay at the current level.

MR. BOOTH: Does that presume there would be a dividend projection if interest rates stay at the current level which would produce dividends greater than or equal to the company's current scale?

MR. HUNT: The way I see the seriousness of the replacement problem, we need to reconsider the age-old prohibition of projected dividends. In order to have a rational scheme for defending existing policies, projected dividends may be essential.

MR. BOOTH: Now that we have 8% proposed as an interest rate for the NAIC cost disclosure index, are there any other suggestions?

MR. GUSTAFSON: In response to Jim's comment, at Northwestern we have opposed the rate of return as a preferred method of cost comparison.

With specific reference to the replacement issue, we are one of the companies that do provide freely on request, an inforce ledger that shows among other things, what we choose to call the comparable interest rate. What the ledger shows is what one would have to earn, net after taxes on an outside fund if he were to replace his present policy with a Northwestern term insurance policy and invest the difference. We have a sensitivity about splitting the policy and the rate of return. Therefore, we use this comparable interest rate. We have a brochure that satisfies us intellectually that we have not split the policy.

We have been aware for years of the extreme sensitivity of the interest-adjusted index to the choice of the interest rate. In our own analysis at the Northwestern, where we believe we have a sophisticated handle on how we price our products, we feel that the unbiased interest rate that would not distort the choice between high premium and low premium plans is our dividend interest rate. However, that is not necessarily the right choice from the consumers' point of view. His choice is a relatively quite secure after-tax investment.

We would agree that the move from 4% to 5% was a sound move and that, under current economic conditions, 5% is probably too low. We are convinced 8% is too high since it is not a realistic conservative long term investment rate, net after tax, for the ordinary consumer. This is a difficult conflict since the unbiased rate and the consumer's rate are not really totally reconcilable.

In our case, we quarrel with Trow's categorical statement that his adjustment enables the method to be used to compare dissimilar policies. We feel it frees the methodology from the severe constraint applicable to the interest-adjusted index and our rhetoric is that Trow's index will enable you to compare with some validity mildly dissimilar policies. How do you draw the line then?

MR. TROWBRIDGE: I agree with you that my method does free us from some of the limitations of the interest-adjusted method. It is subject to the important question of what should the interest rate be. It should be pointed out that as long as the NAIC method is used in comparing similar policies, the interest assumption does not have much sensitivity. It does have sensitivity if dissimilar policies are compared.

The question of what the interest rate should be really boils down to whether we can get inflation under control or not. The interest rate is basically a function of inflation. In a non-inflationary economy, choosing the interest rate is not much of a problem. If one believes that inflation will remain at present levels or even at higher levels, then the interest rate should be higher than 5%. If we get inflation under control, it is quite conceivable that the 5% rate makes sense.

