The most recent report of the Technical Advisory Committee on Credit Morbidity and Mortality Experience will be available from Mr. Galloway for additional information.

Please call upon me if you need anything further in considering your response to this request.

LIFE INSURANCE (C3) SUBCOMMITTEE

Reference:
1978 Proc. Vol. II p. 379
1978 Proc. Vol. I p. 472

Hon. James W. Newman, Acting Chairman – Virginia

AGENDA

1. Report of the Standard Nonforfeiture and Reserve Valuation Laws task force.
2. Report of the Life Insurance Cost Disclosure Task Force.
3. Report of the Replacement of Life Insurance Task Force.
4. Report of the Task Force on Federal Task Treatment of Investment Annuity Contracts.
5. Report of the Model Group Life Insurance Law Task Force.
6. Any other matters brought before the subcommittee.

TABLE OF CONTENTS

The Life Insurance (D3) Subcommittee met in the F-G Ballroom of the Las Vegas Hilton Hotel in Las Vegas, Nevada at 10:45 a.m. A quorum was present and James W. Newman, Acting Chairman, chaired the meeting. The following subcommittee members or their representatives were present:

Sherman A. Bernard, Louisiana; Edward J. Birrane, Jr., Maryland; James L. Wadhams, Nevada; Rolando Cruz, Puerto Rico; Millard Oakley, Tennessee; Durwood Manford, Texas; James W. Newman, Acting Chairman, Virginia.

1. Report of the Life Insurance Cost Disclosure Task Force

Erma Edwards of the Nevada Department, who is Chairman of the task force, described the activities of the task force since the June 1978 NAIC meeting. The task force report is attached. An advisory committee has been appointed to assist the task force in monitoring the impact of the NAIC Model Life Insurance Solicitation Regulation. Another advisory committee has been appointed to work with the task force on a study of the methods to detect the manipulation of policy values and dividends to produce unrealistically attractive cost indices.

The task force asked that a report of the Society of Actuaries Committee on Dividend Philosophy be received by the (C3) Life Insurance Subcommittee as an exposure draft. The report includes a discussion of (1) an opinion on actuarial principles and practices in connection with dividend calculations and illustrations, and (2) an actuarial certification of dividend calculations.

The task force also asked that a comprehensive report of the Policy Lapsation Advisory Committee be received as an exposure draft. This report includes a proposed lapse rate disclosure system. The task force's report was received by the subcommittee (attached).

Commissioner Wilde of Wisconsin described his state's life insurance solicitation regulation that will become effective on January 1, 1979, and pointed out a number of differences between the Wisconsin regulation and the NAIC model. Copies of the Wisconsin regulation and other related information will be given to the members of the Life Insurance Cost Disclosure Task Force. Commissioner Anderson of Iowa spoke briefly and urged that all states adopt the NAIC model Life Insurance Solicitation Regulation that have not done so. Jack Blaine of the American Council of Life Insurance urged that the Life Insurance Cost Disclosure Task Force not consider changing the NAIC model regulation until the study to monitor the impact of the model is complete.

2. Report of the Replacement of Life Insurance Task Force

The report of the Replacement of Life Insurance Task Force was made by Director Barry Balka of Nebraska. The proposed Model Life Insurance Replacement Regulation was presented to the members of the subcommittee with information that changes have been made relating to the delivery of a Comparative Information Form to the insured/buyer as discussed at the NAIC annual meeting in June 1978. The proposed regulation and the advisory committee's report are attached. Director Balka asked that the task force and the advisory committee be discharged if the proposed model regulation is adopted.

Ronald J. Doane, Chairman of the Advisory Committee, asked that a minor change be made in the Comparative Information Form concerning "borrowing on existing insurance" and recommended adoption of the proposed regulation.

A number of those present including Robert J. DeMichelis, American Council of Life Insurance; Carl T. Barnes, Kansas City Life; H. James Dowds, National Association of Life Underwriters; Robert L. Hill, Aetna Life and Casualty Company; Robert O. Fleckenstein, Metropolitan Life Insurance Company; William F. Hannen, Prudential Insurance Company; James McDonald, New England Life Insurance Company and William M. Simon, Jr., Old American Insurance Company recommended adoption of the model as presented.

John Glover of the Travelers Insurance Company recommended that Section 7.C(5) of the proposed Regulation and also Exhibit A be amended with regard to a "20-day free look" after issue and recommended a 14-day delay in issue coupled with a 10-day to 20-day free look in those cases where one company is replacing the policy of another company. Mr. Glover's position was supported by Walter G. Nelson of State Farm Life Insurance Company and Paul Brown of the Bankers Life.

Michael S. Mullen of the Kansas Insurance Department urged the strictest enforcement of whatever regulation is in effect with emphasis on the acts of agents.

A motion was made to adopt the report of the task force including the proposed regulation and the motion passed.

3. Report of the Task Force on Federal Tax Treatment of Investment Annuity Contracts

This task force did not make a report.

4. Report of the Model Group Life Insurance Law Task Force

The report of the Model Group Life Insurance Law Task Force was made by Thomas J. Kelly, Jr. of the New York Insurance Department. The report requested an extension of time for further development of the model law. Robert J. Finnegan of the Professional Mas-Marketing Administrators (PIMA) expressed the interest of his association in the work of the task force and his association's willingness to serve on the advisory committee. The task force's report was received by the subcommittee.

5. Report of the Standard Nonforfeiture and Reserve Valuation Laws Task Force

John Montgomery of the California Department, who is the Vice Chairman of the task force, presented the task force's report. ~~The task force adopted four (4) actuarial guidelines and recommended that the (A5) Financial Condition Examination Subcommittee include them in the Financial Condition Examiners Handbook~~. *[Deleted by the parent (C) since it duplicated action taken in Washington, D.C. See p. 373.]* Actuarial guidelines regarding Deposit Term Life Insurance and distinguishing annuities from life insurance are still under development. The task force reported that the development of a new mortality table is not yet complete. Mr. Montgomery also reported that the task force is considering a revision of the Standard Nonforfeiture Law to eliminate the necessity of changes in the laws of each state when economic and experience factors change. The task force's report, which did not contain any recommendations for action at this meeting, was received by the subcommittee and is attached.

As there was no further business, the meeting adjourned at 12:30 p.m.

Hon. James W. Newman, Acting Chairman, Virginia; Hon. J. Richard Barnes, Colorado; Hon. Manuel A. Chaco, Guam; Hon. Sherman A. Bernard, Louisiana; Hon. Edward J. Birrane, Jr., Maryland; Hon. James L. Wadhams, Nevada; Hon. Rolando Cruz, Puerto Rico; Hon. Thomas J. Caldarone, Jr., Rhode Island; Hon. Millard Oakley, Tennessee; Hon. Durwood Manford, Texas.

Life Insurance (C3) Cost Disclosure Task Force

Las Vegas, Nevada
December 2, 1978

At the October meeting the task force heard reports from the advisory committees on policy lapsation and the Society of Actuaries Committee on Dividend Philosophy. Pursuant to the recommendation of the Government Liaison (EX5) Subcommittee that a mechanism for monitoring the impact of the NAIC Model Life Insurance Solicitation Regulation be developed, the task force appointed an additional advisory committee to be chaired by Charles Greeley, Vice President and Actuary, Metropolitan Life Insurance Company. Some studies have been begun on this subject and the results of these will be made available to task force and advisory committee members in the near future.

Among the areas needing further study that were identified in the task force report adopted at the December 1975 meeting was a study of methods to detect the manipulation of policy values and dividends which produces unrealistically attractive cost indices. A new advisory committee appointed to work on this project will be chaired by Julius Vogel, Vice President and Chief Actuary of the Prudential Insurance Company. A list of members of both these advisory committees appears at the end of this report.

At the December 1978 meeting, the task force received a report from the Society of Actuaries Committee on Dividend Philosophy (attached). The Society report includes an exposure draft of an Opinion on Actuarial Principles and Practices in connection with dividend calculations and illustrations. Also included in the report is an exposure draft of an actuarial certification on dividend calculations which if adopted by the NAIC, would be included in the annual statement. The task force requests comments from all interested persons.

The task force was informed that Mr. J. Edwin Matz will be succeeded by Mr. Edwin B. Lancaster, Chairman of the Society Committee.

The task force received a comprehensive report from Helen Noniewicz, LIMRA, chairman of the Policy Lapsation Advisory Committee (attached).

The report begins by addressing the questions posed by the task force at the organizational meeting of the advisory committee and includes a proposed lapse rate disclosure system that can be incorporated into the annual statement. The report is the most thorough study of the lapsation problem to be presented to the NAIC to date.

The task force concluded that the report should have at least a six month exposure period before it could be considered for adoption. The task force would like to express its appreciation to the Lapsation Committee for the time and effort they have spent in producing this excellent report.

Both reports are received and attached as exposure drafts and written comments are solicited from all interested persons.

The December 1978 meeting adjourned at 6:00 p.m.

Erma Edwards, Chairman, Nevada; James Montgomery III, District of Columbia; Bill Homan, Iowa; M. Berri Balka, Nebraska; Frank Howatt, Oregon.

****

Advisory Committee on monitoring the impact of the
NAIC Life Insurance Solicitation Model Regulation

Charles Greeley, Chairman, Metropolitan Life Insurance Company; I. Edward Price, Prudential Life Insurance Company; Richard Miller, Southwestern Life Insurance Company; Harold Ingraham, New England Mutual Life Insurance Co.; Seth Macon, Jefferson Standard Life Insurance Co.; Robert Hill, Aetna Life Insurance Company.

Nonmember Staff to the Advisory Committee: William A. White and Matthew Greenwald of the ACLI.

****

Advisory Committee on Cost Index Manipulation

Julius Vogel, Chairman, Prudential Life Insurance Company; Kenneth Clark, Lincoln National Life Insurance Company; Walter Miller, New York Life Insurance Company; Richard Murphy, Aetna Life Insurance Company; Paul Overberg, Allstate Life Insurance Company; Norman Peacor, Massachusetts Mutual Life Insurance Company; Thomas Eason, Security Mutual (Nebraska) Life Insurance Company.

Replacement: The NAIC Life Insurance Replacement Model Regulation

(As Adopted by the NAIC, December 6, 1978)

Section 1. Statutory Authority

This Regulation is promulgated by (title of supervisory authority) to implement Section _____ of the insuance laws:

Section 2. Purpose

The purpose of this Regulation is:

A. To regulate the activities of insurers and agents with respect to the replacement of existing life insurance;

B. To protect the interests of life insurance policyowners by establishing minimum standards of conduct to be observed in the replacement or proposed replacement of existing life insurance by:

1. Assuring that the policyowner receives information with which a decision can be made in his or her own best interest;

2. Reducing the opportunity for misrepresentation and incomplete disclosures; and

3. Establishing penalties for failure to comply with the requirements of this Regulation.

Section 3. Definition of Replacement

"Replacement" means any transaction in which new life insurance is to be purchased, and it is known or should be known to the proposing agent, or to the proposing insurer if there is no agent, that by reason of such transaction, existing life insurance has been or is to be:

A. Lapsed, forfeited, surrendered, or otherwise terminated;

B. Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values;

C. Amended so as to effect either a reduction in benefits or in the term for which coverage would otherwise remain in force or for which benefits would be paid;

D. Reissued with any reduction in cash value; or

E. Pledged as collateral or subjected to borrowing, whether in a single loan or under a schedule of borrowing over a period of time for amounts in the aggregate exceeding twenty-five percent (25%) of the loan value set forth in the policy.

Section 4. Other Definitions

A. "Cash Dividend" means the current illustrated dividend which can be applied toward payment of the gross premium.

B. "Conservation" means any attempt by the existing insurer or its agent to continue existing life insurance in force when the existing insurer has received a Comparative Information Form as required by Section 7 C 4 of this Regulation from a replacing insurer. A conservation effort does not include such routine administrative procedures like late payment reminders, late payment offers or reinstatement offers.

C. "Direct-Response Sales" means any sale of life insurance where the insurer does not utilize an agent in the sale or delivery of the policy.

D. "Existing Insurer" means the insurance company whose policy is or will be changed or terminated in such a manner as described within the definition of "replacement."

E. "Existing Life Insurance" means any life insurance in force including life insurance under a binding or conditional receipt or a life insurance policy that is within an unconditional refund period, but excluding life insurance obtained through the exercise of a dividend option.

F. "Generic Name" means a short title which is descriptive of the premium and benefit patterns of a policy or a rider.

G. "Replacing Insurer" means the insurance company that issues a new policy which is a replacement of existing life insurance.

H. "Sales Proposal" means individualized, written sales aids of all kinds, excluding Comparative Information Forms and Policy Summaries, which are used by an insurer, agent or broker in comparing existing life insurance to proposed life insurance in order to recommend the replacement or conservation of existing life insurance. Sales aids of a generally descriptive nature, which are maintained in the insurer's advertising compliance file, shall not be considered a Sales Proposal within the meaning of this definition.

Section 5. Exemptions

Unless otherwise specifically included, this Regulation shall not apply to:

A. Annuities;

B. Individual credit life insurance;

C. Group life insurance, group credit life insurance, and life insurance policies issued in connection with a pension, profit-sharing or other benefit plan qualifying for tax deductibility of premiums, provided, however, that as to any plan described in this subsection, full and complete disclosure of all material facts shall be given to the administrator of any plan to be replaced;

D. Variable life insurance under which the death benefits and cash values vary in accordance with unit values of investments held in a separate account;

E. An application to the existing insurer that issued the existing life insurance and a contractual change or conversion privilege is being exercised;

F. Existing life insurance that is nonconvertible term life insurance policy which will expire in five years or less and cannot be renewed; or

G. Proposed life insurance that is to replace life insurance under a binding or conditional receipt issued by the same company.

Section 6. Duties of Agents

A. Each agent shall submit to the replacing insurer with or as part of each application for life insurance:

1. A statement signed by the applicant as to whether or not such insurance will replace existing life insurance; and

2. A signed statement as to whether or not the agent knows replacement is or may be involved in the transaction.

B. Where a replacement is involved, the agent shall:

1. Present to the applicant, not later than at the time of taking the application, a "Notice Regarding Replacement of Life Insurance" in the form as described in Exhibits A or B, whichever is applicable, or other substantially similar form approved by the commissioner. The notice must be signed by and left with the applicant.

2. Present to the applicant, not later than at the time of taking the application, a Comparative Information Form as described in Exhibit D. (Substantially equivalent forms may be used with the prior approval of the commissioner.) If more than one existing life insurance policy is to be replaced, a separate Comparative Information Form is to be provided for each such policy or separate information is to be provided in the Comparative Information Form for each such policy, and a summary of all the separate policy information to the extent possible must be included. The agent must include in the Comparative Information Form all of the information required to be in that Form, except that information concerning the existing life insurance policy that cannot be obtained from that policy itself. The Comparative Information Form must be signed by the agent and the applicant and a copy left with the applicant.

3. Leave with the applicant the original or a copy of all Sales Proposals used for presentation to the applicant.

4. Submit to the replacing insurer with the application, a copy of the "Notice Regarding Replacement of Life Insurance" signed by the applicant, a copy of the Comparative Information Form signed by the agent and the applicant, and a copy of all Sales Proposals used for presentation to the applicant.

C. Each agent who uses a Sales Proposal when conserving existing life insurance shall:

1. Leave with the applicant the original or a copy of all Sales Proposals used in the conservation effort; and

2. Submit to the existing insurer a copy of all Sales Proposals used in the conservation effort.

Section 7. Duties of Replacing Insurers

Each replacing insurer shall:

A. Inform its field representatives of the requirements of this Regulation.

B. Require with or as part of each completed application for life insurance:

1. A statement signed by the applicant as to whether or not such insurance will replace existing life insurance; and

2. A statement signed by the agent as to whether or not he or she knows replacement is or may be involved in the transaction.

C. Where a replacement is involved:

1. Require from the agent with the application for life insurance a copy of the "Notice Regarding Replacement of Life Insurance" signed by the applicant, a copy of the Comparative Information Form signed by the agent and the applicant, and a copy of all Sales Proposals used for presentation to the applicant.

2. Verify the substantial accuracy of information concerning the proposed policy furnished to the applicant in the Comparative Information Form. If the information concerning that policy is not substantially accurate, the replacing insurer must obtain a Comparative Information Form signed by the agent and the applicant which includes substantially accurate information before it can begin to process the application for the proposed policy.

3. Unless otherwise modified by the provisions of Sections 7 C 5 or 6 of this Regulation, furnish to the applicant a Policy Summary in accordance with the provisions of the Life Insurance Solicitation Regulation.

(Alternative Provision)

If the NAIC Model Life Insurance Solicitation Regulation has not been promulgated, then, for the purpose of this Regulation, the following alternative to Section 7 C 3 should be used:

3. Unless otherwise modified by the provisions of Sections 7 C 5 or 6 of this Regulation, furnish the applicant with a Policy Summary at or prior to the time of policy delivery. For the purpose of this Regulation, a Policy Summary means a written statement describing the elements of the policy, including, but not limited to:

a. The name and address of the insurance agent or if no agent is involved, a statement of the procedure to be followed in order to receive responses to inquiries regarding the Policy Summary.

b. The full name and Home Office or Administrative Office address of the company in which the life insurance policy is to be or has been written.

c. The generic name of the basic policy and each rider.

d. The following amounts, where applicable, for the first five policy years, the tenth and twentieth policy years, and at least one age from sixty through sixty-five or maturity, whichever is earlier:

(1) The annual premium for the basic policy.

(2) The annual premium for each optional rider.

(3) Guaranteed amount payable upon death, at the beginning of the policy year regardless of the cause of death other than suicide, or other specifically enumerated exclusions, which is provided under the basic policy and each rider shown separately.

(4) Total guaranteed cash surrender values at the end of the year with values shown separately for the basic policy and each rider.

(5) Cash dividends payable to the end of the year with values shown separately for the basic policy and each rider. (Dividends need not be displayed beyond the twentieth policy year.)

(6) Guaranteed endowment amounts payable under the policy which are not included under guaranteed cash surrender values above.

e. A Policy Summary which includes dividends shall also include a statement that dividends are based on the company's current dividend scale and are not guaranteed.

f. The effective policy loan annual percentage interest rate, if the policy contains such a loan provision, specifying whether this rate is applied in advance or in arrears. If the policy loan interest rate is variable, the Policy Summary is to include the maximum annual percentage rate.

g. The date on which the Policy Summary is prepared.

h. A statement to the effect that the presentation does not recognize that, because of interest, a dollar in the future has less value than a dollar today, unless the Policy Summary includes index figures which recognize the time value of money. If index figures are included in the Policy Summary, the applicant must receive written notification at the time the Policy Summary is delivered that such figures should only be used for comparing the relative costs of similar policy.

The Policy Summary must consist of a separate document. All information required to be disclosed must be set out in such a manner as to not minimize or render any portion thereof obscure. Any amounts which remain level for two or more years of the policy may be represented by a single number if it is clearly indicated what amounts are applicable for each policy year. Amounts in item "d" in this section shall be listed in total, not on a per thousand nor per unit basis. If more than one insured is covered under one policy or rider, guaranteed death benefits shall be displayed separately for each insured or for each class of insureds if death benefits do not differ within the class. Zero amounts shall be displayed as zero and shall not be displayed as a blank space.

4. Send to the existing insurer a Section 7 C 1 verified Comparative Information Form as required by Sections 7 C 1 and 2 within three working days of the date the application and a substantially accurate Comparative Information Form are received at its Home or Regional Office, or the date its policy is issued, whichever is sooner.

5. Delay, if it is not also the existing insurer, the issue of its policy for twenty days after it sends the existing insurer a copy of the Policy Summary, unless it provides in its "Notice Regarding Replacement of Life Insurance" and in either its policy or in a separate written notice that is delivered with the policy that the applicant has a right to an unconditional refund of all premiums paid, which right may be exercised within a period of twenty days commencing from the date of delivery of the policy, and it sends the Policy Summary required by this Section to the existing insurer within three working days of the date its policy is issued, in which event the replacing insurer may issue its policy immediately.

6. Provide, if it is also the existing insurer, the policyowner a Policy Summary for the new policy prepared in accordance with Section 7 C 3, prior to accepting the applicant's initial premium or premium deposit, unless the replacing insurer provides in its "Notice Regarding Replacement of Life Insurance" and in either its policy or in a separate written notice that is delivered with the policy that the applicant has a right to an unconditional refund of all premiums paid, which

right may be exercised within a period of twenty days commencing from the date of delivery of the policy, in which event, the replacing insurer must furnish the Policy Summary at or prior to delivery of the policy.

7. Maintain copies of the "Notice Regarding Replacement of Life Insurance," the verified Comparative Information Form, the Policy Summary, and all Sales Proposals used, and a replacement register, cross indexed, by replacing agent and existing insurer to be replaced, for at least three years or until the conclusion of the next succeeding regular examination by the Insurance Department of its state or domicile, whichever is later.

Section 8. Duties of Insurers With Respect to Direct-Response Sales

Each insurer shall:

A. Inform its responsible personnel of the requirements of this Regulation.

B. Require with or as part of each completed application for life insurance a statement signed by the applicant as to whether or not such insurance will replace existing life insurance.

C. Where no replacement is proposed by an insurer in the solicitation of a direct-response sale and a replacement is involved:

1. At the time the policy is mailed to the applicant, include a "Notice Regarding Replacement of Life Insurance" in a form substantially as described in Exhibit C.

D. Where a replacement is proposed by an insurer in the Solicitation of a direct-response sale and a replacement is involved:

1. Request from the applicant with or as part of the application a list of all existing life insurance to be replaced. Such existing life insurance shall be identified by name of insurer.

2. If the applicant furnishes the names of the existing insurers, then the replacing direct-response insurer shall mail the applicant a "Notice Regarding Replacement of Life Insurance" in a form substantially as described in Exhibit C within three working days after receipt of the application and shall comply with all of the provisions of Sections 7 C 3, 5, 6, and 7, except that it need not meet the requirements of this Regulation concerning Comparative Information Forms and need not maintain a replacement register required by Section 7 C 7.

3. If the applicant does not furnish the names of the existing insurers, then the replacing direct-response insurer shall at the time the policy is mailed to the applicant, include a "Notice Regarding Replacement of Life Insurance" in a form substantially as described in Exhibit C.

Section 9. Duties of the Existing Insurer

Each existing insurer shall inform its responsible personnel of the requirements of this Regulation. Each existing insurer, or such insurer's agent, that undertakes a conservation effort shall:

A. Within twenty days from the date the Comparative Information Form required by Section 7 C 4 is received, either furnish the policyowner with the Comparative Information Form received from the replacing insurer and include in it all of the information concerning the existing life insurance that was not completed and correct any information that was inaccurately completed by the replacing agent, or furnish the policyowner with a Policy Summary for the existing life insurance. Such Policy Summary shall be completed in accordance with the provisions of the Life Insurance Solicitation Regulation, except that information relating to premiums, cash values, death benefits and dividends, if any, shall be computed from the current policy year of the existing life insurance. The Policy Summary shall include the amount of any outstanding policy indebtedness, the sum of any dividend

accumulations or additions, and may include any other information that is not in violation of any regulation or statute. Life insurance cost index and equivalent level annual dividend figures need not be included in the Policy Summary. If index figures are included in the Policy Summary, the policyowner must receive written notification at the time the Policy Summary is delivered that such figures should only be used for comparing the relative costs of similar policies.

(ALTERNATIVE PROVISION)

If the NAIC Model Life Insurance Solicitation Regulation has not been promulgated, then, for the purposes of this Regulation, the following alternative provision should be used for Section 9 A:

A. *Within twenty days from the date the Comparative Information Form required by Section 7 C 4 is received, either furnish the policyowner with the Comparative Information Form received from the replacing insurer and include in it all of the information concerning the existing life insurance that was not completed and correct any information that was inaccurately completed by the replacing agent, or furnish the policyowner with a Policy Summary for the existing life insurance. Such Policy Summary shall include all of the information required in Section 7 C 3, except that information relating to premiums, cash values, death benefits and dividends, if any, shall be computed from the current policy year of the existing life insurance. The Policy Summary shall include the amount of any outstanding policy indebtedness, the sum of any dividend accumulations or additions, and may include any other information that is not in violation of any regulation or statute.*

B. Furnish the replacing insurer with a copy of the fully completed Comparative Information Form or the Policy Summary for the existing life insurance within three working days of the date that the fully completed Comparative Information Form or the Policy Summary is sent by the existing insurer to either its agent or directly to the policyowner.

C. Maintain a file containing the following:

1. Comparative Information Forms required by Section 7 C 4 and Policy Summaries required by Section 7 C 5 received from replacing insurers; and

2. Copies of fully completed Comparative Information Forms or Policy Summaries prepared pursuant to Section 9 A, and all Sales Proposals used to conserve the existing life insurance.

This material shall be indexed by replacing insurer and held for three years or until the conclusion of the next regular examination conducted by the Insurance Department of its domicile, whichever is later.

Section 10. Penalties

A. Any insurer, agent, representative, officer or employee of such insurer failing to comply with the requirements of this Regulation shall be subject to such penalties as may be appropriate under the Insurance Laws of ( ).

B. This Regulation does not prohibit the use of additional material other than that which is required that is not in violation of this Regulation or any other ( ) Statute or Regulation.

C. Policyowners have the right to replace existing life insurance after indicating in or as part of the applications for life insurance that such is not their intention; however, patterns of such action by policyowners who purchase the replacing policies from the same agent shall be deemed prima facie evidence of the agent's knowledge that replacement was intended in connection with the sale of those policies, and such patterns of action shall be deemed prima facie evidence of the agent's intent to violate this Regulation.

Section 11. Separability

If any provision of this Regulation shall be held invalid, the remainder of the Regulation shall not be affected thereby.

EXHIBIT A

(To be used where the existing and proposed policies are written by different companies.)

(Name, address and telephone number of the insurance company)

Important Notice Regarding Replacement of Life Insurance

Our agent is recommending to you that you purchase a life insurance policy from us. In connection with this purchase, you have indicated either as a result of his recommendation or at your own initiative, that you may terminate or change your existing policy issued by another insurance company or that you may obtain a loan from that company against your policy to pay premiums on the proposed policy. Any of these actions is a replacement of life insurance. This notice must be given to you, along with a form including preliminary information comparing the proposed policy with your existing policy to be replaced. Please read this notice and the Comparative Information Form carefully.

Whether it is to your advantage to replace your existing insurance coverage, only you can decide. It is in your best interest, however, to have adequate information before a decision to replace your present coverage becomes final so that you may understand the essential features of the proposed policy and of your existing insurance coverage.

To this end, we are required to give you a Policy Summary including complete information on the proposed policy no later than when that policy is delivered to you. In addition, we are required to notify the insurance company that issued your existing policy. That company may then furnish you additional information concerning your existing policy. You may want to contact that company or its agent for further information and advice or discuss your purchase with other advisors. The information you receive will be of value to you in reaching a final decision.

If either the proposed policy or the existing insurance you intend to replace is a participating policy, you should be aware that dividends may materially reduce the cost of insurance and are an important factor to consider. Dividends, however, are not guaranteed.

You should also recognize that a policy which has been in existence for a period of time may have certain advantages to you over a new policy. If the policy coverages are basically similar, the premiums for a new policy may be higher because rates increase as your age increases. Under your existing policy, the period of time during which the issuing company could contest the policy because of a material misstatement or omission on your application, or deny coverage for death caused by suicide, may have expired or may expire earlier than it will under the proposed policy. Your existing policy may have options which are not available under the policy being proposed to you or may not come into effect under the proposed policy until a later time during your life. Also, your proposed policy's cash values and dividends, if any, may grow slower initially because the company will incur the cost of issuing your new policy. On the other hand, the proposed policy may offer advantages which are more important to you.

If you are considering borrowing against your existing policy to pay the premiums on the proposed policy, you should understand that in the event of your death, the amount of any unpaid loan, including unpaid interest, will be deducted from the benefits of your existing policy thereby reducing your total insurance coverage.

After we have received your application and notified the other insurance company you will have twenty days from the date the proposed policy is delivered to you to cancel the policy issued on your application and receive back all payments you made to us.

(ALTERNATE PARAGRAPH IF 20-DAY MONEY-BACK GUARANTEE IS NOT PROVIDED.)

We are required by state regulation to delay the issuance of the policy for which you are making application for twenty days from the date on which we send your existing insurer notification that their policy will be replaced.

Caution

If, after studying the information made available to you, you decide to replace the existing life insurance with our life insurance policy, you are urged not to take action to terminate or alter your existing life insurance coverage until after you have been issued the new policy, examined it and have found it to be acceptable to you. If you should terminate or otherwise materially alter your existing coverage and fail to qualify for the life insurance for which you have applied, you may find yourself unable to purchase other life insurance or able to purchase it only at substantially higher rates.

I have received and read a copy of this Replacement Notice.

(Signed) _____ Date _____

Applicant

****

EXHIBIT B

(To be used where the existing and proposed policies are written by the same company.)

(Name, address and telephone number of the insurance company)

Important Notice Regarding Replacement of Life Insurance

Our agent is recommending that you purchase a life insurance policy from us. In connection with this purchase, you have indicated either as a result of his recommendation or at your own initiative, that you may terminate or change your existing policy issued by our company or that you may obtain a loan from our company against your existing policy to pay premiums on the proposed policy. Any of these actions is a replacement of life insurance. This notice must be given to you, along with a Comparative Information Form which includes preliminary information comparing the proposed policy with your existing policy to be replaced. Please read this notice and the Comparative Information Form carefully.

Whether it is to your advantage to replace your existing insurance coverage, only you can decide. It is in your best interest, however, to have adequate information before a decision to replace your present coverage becomes final so that you may understand the essential features of the proposed policy and of your existing insurance coverage.

To this end, we are required to give you a Policy Summary including complete information on the proposed policy no later than when the policy is delivered to you. In addition, we will, at your request, furnish you additional information concerning your existing policy. You may want to discuss your purchase with other advisors. The information you receive will be of value to you in reaching a final decision.

If either the proposed policy or the existing insurance you intend to replace is a participating policy you should be aware that dividends may materially reduce the cost of insurance and are an important factor to consider. Dividends, however, are not guaranteed.

You should also recognize that a policy which has been in existence for a period of time may have certain advantages to you over a new policy. If the policy coverages are basically similar, the premiums for a new policy may be higher because rates increase as your age increases. Under your existing policy, the period of

time during which our company could contest the policy because of a material misstatement or omission on your application, or deny coverage for death caused by suicide, may have expired or may expire earlier than it will under the proposed policy. Your existing policy may have options which are not available under the policy being proposed to you or may not come into effect under the proposed policy until a later time during your life. Also, your proposed policy's cash values and dividends, if any, may grow slower initially because the company will incur the cost of issuing your new policy. On the other hand, the proposed policy may offer advantages which are more important to you.

If you are considering borrowing against your existing policy to pay the premiums on the proposed policy, you should understand that in the event of your death, the amount of any unpaid loan, including unpaid interest, will be deducted from the benefits of your existing policy thereby reducing your total insurance coverage.

(ADDITIONAL PARAGRAPH IF TWENTY-DAY MONEY-BACK GUARANTEE IS PROVIDED.)

After we have issued your policy, you will have twenty days from the date the new policy is delivered to you to cancel the policy issued on your application and receive back all payments you made to us.

Caution

If, after studying the information made available to you, you do decide to replace the existing life insurance with our company with a new life insurance policy issued by our company, you are urged not to take action to terminate or alter your existing life insurance coverage until after you have been issued the new policy, examined it and have found it acceptable to you. If you should terminate or otherwise materially alter your existing coverage and fail to qualify for the life insurance for which you have applied, you may find yourself unable to purchase other life insurance or able to purchase it only at substantially higher rates.

I have received and read a copy of this Replacement Notice.

(Signed) _____ Date _____
Applicant

****

EXHIBIT C

(Name, address and telephone number
of the insurance company)

Important Notice Regarding Replacement of Life Insurance

You have indicated that you intend to replace an existing life insurance policy or policies in connection with the purchase of our life insurance policy. As a result, we are required to send you this notice. Please read it carefully.

Whether it is to your advantage to replace your existing insurance coverage, only you can decide. It is in your best interest, however, to have adequate information before a decision to replace your present coverage becomes final so that you may understand the essential features of the proposed policy and your existing insurance coverage.

You may want to contact your existing life insurance company or its agent for additional information and advice or discuss your purchase with other advisors. The information you receive should be of value to you in reaching a final decision.

If either the proposed policy or the existing insurance you intend to replace is a participating policy, you should be aware that dividends may materially reduce the cost of insurance and are an important factor to consider. Dividends, however, are not guaranteed.

You should recognize that a policy which has been in existence for a period of time may have certain advantages to you over a new policy. If the policy coverages are basically similar, the premiums for a new policy may be higher because rates increase as your age increases. Under your existing policy, the period of time during which the issuing company could [contest the policy because of a material misrepresentation or omission concerning the medical information requested in your application, or]* deny coverage for death caused by suicide, may have expired or may expire earlier than it will under the proposed policy. Your existing policy may have options which are not available under the policy being proposed to you or may not come into effect under the proposed policy until a later time during your life. Also, your proposed policy's cash values and dividends, if any, may grow slower initially because the company will incur the cost of issuing your new policy. On the other hand, the proposed policy may offer advantages which are more important to you.

If you are considering borrowing against your existing policy to pay the premiums on the proposed policy, you should understand that in the event of your death, the amount of any unpaid loan, including unpaid interest, will be deducted from the benefits of your existing policy thereby reducing your total insurance coverage.

(ADDITIONAL PARAGRAPH IF DIRECT-RESPONSE INSURER'S SOLICITATION PROPOSED REPLACEMENT, AND A TWENTY-DAY MONEY-BACK GUARANTEE IS PROVIDED BY THE INSURER.)

After we have issued your policy, you will have twenty days from the date the new policy is received by you to notify us you are cancelling the policy issued on your application and you will receive back all payments you made to us.

You are urged not to take action to terminate or alter your existing life insurance coverage until you have been issued the new policy, examined it and have found it acceptable to you.

****

EXHIBIT D

(Name, address and telephone number
of insurance company)

Comparative Information Form

Name of Proposed Insured _____ Address _____ Date of Birth _____

GENERAL INFORMATION	EXISTING LIFE INSURANCE	PROPOSED LIFE INSURANCE
Name of Company		
Policy Number		
Basic Policy Generic Name		
Name of Basic Policy		
Rider 1; Generic Name		
Rider 2; Generic Name		
Rider 3; Generic Name		
Issue Age		
Date of Issue		
Contestable Period Expires		
Suicide Clause Expires		

---

* **Note:** *Use bracketed language only when the application asks health questions.*

PREMIUM DATA/DEATH BENEFITS	PREMIUM MODE: ___ AMOUNT	AGE PAYABLE TO ___	DEATH BENEFIT	AGE BENEFIT CEASES	PREMIUM MODE: ___ AMOUNT	AGE PAYABLE TO ___	DEATH BENEFIT	AGE BENEFIT CEASES
Basic Policy	$		$		$		$	
Rider 1	$		$		$		$	
Rider 2	$		$		$		$	
Rider 3	$		$		$		$	
Accidental Death Benefit	$		$		$		$	
Option to Purchase Additional Insurance	$		$ (Option Ages: _____)		$		$ (Option Ages: _____)	
Waiver of Premium Benefit	$		$xxx		$		$xxx	
Disability Income Benefit	$		$xxx (Monthly Income: $_____)		$		$xxx (Monthly Income: $_____)	
Total Current Premium	$							

CASH VALUES/DIVIDENDS	*GUARANTEED CASH VALUE	*DIVIDENDS	*GUARANTEED CASH VALUE	*DIVIDENDS
Currently (last policy anniversary)	$	$	$	$
1 year hence	$	$	$	$
5 years hence	$	$	$	$
10 years hence	$	$	$	$
At Age 65	$	$	$	$

* Current Death Benefit of Div. Adds	$	
* Current Cash Value of Div. Adds	$	
* Current Accum. Div.	$	
* Current Policy Loan	$	
Maximum Policy Loan Interest Rate	_____%	Maximum Policy Loan Interest Rate _____%
* Dividends are based on the current (19___) scale.		* Dividends are based on the current (19___) scale.

* Dividends, policy loan and certain guaranteed cash value information concerning your existing insurance may not be known to our agent. Dividends are not guaranteed. However, they may materially reduce the cost of insurance and are an important factor to consider. Thus, if dividends or other figures have been omitted from this Comparative Information Form, you should not reach a final decision to replace your existing insurance until you have them. You may obtain the omitted figures from the company that issued your existing policy. We will notify that company of your intent to replace your existing policy.

Agent's Statement

1. The primary reasons for my recommending the proposed replacement of existing life insurance by new life insurance are:*

_____

_____

2. My recommendations as to the existing life insurance is that it be:

_____Not Changed _____Lapsed _____Surrendered _____Reduced Paid-Up _____Extended Term

Other (Explain) _____

Borrowed Upon (Explain and state the amount to be borrowed) _____

_____

3. The existing life insurance does not meet the insured/buyer's needs for insurance because:*

_____

_____

* Specific reasons must be given. For example, if you believe the existing life insurance cannot meet the insured/buyer's needs, you must specify why you think it does not.

Instructional Notes for Agent

1. Existing life insurance must be identified by name of insurer and the policy number. In the event that a policy number has not been assigned by the existing insurer, alternative identification information such as an application or receipt number must be shown.

2. If the premium for the basic policy or any rider or benefit changes, indicate the changes; attached schedule, if necessary.

3. If the death benefit for the basic policy or any rider or benefit changes, indicate the changes; attach schedules, if necessary.

4. If the premium for benefits is not separable from the premium for the basic policy, insert "Included" in Basic Policy Premium.

5. If more than one existing life insurance policy is to be replaced, a separate Comparative Information Form is to be provided for each such policy, or separate information is to be provided in one Comparative Information Form for each such policy, and a summary of all the separate policy information must also be included to the extent possible.

Agent's Certification

I hereby certify that prior to taking an application for a policy, I have provided the applicant with the Notice Regarding Replacement of Life Insurance and that the information in this comparative Information Form is true and correct to the best of my knowledge and belief.

_____ _____

(Signature of Agent) (Date)

I have received and read a copy of this Comparative Information Form.

_____ _____

(Signature of Applicant) (Date)

****

Advisory Committee to the
Replacement Regulation (C3) Task Force

Las Vegas, Nevada
November 30, 1978

Second Report

The NAIC Replacement Regulation Task Force and its Advisory Committee submitted a proposed Life Insurance Replacement Model Regulation to the NAIC at its June 1978 annual meeting in Washington, D.C. That proposal was accepted and adopted in principle. However, the NAIC instructed its task force and the advisory committee to consider adding a requirement in the model whereby some form of disclosure would be made to the insured/buyer prior to or at the time the application for the replacement policy is taken.

Such a requirement is included in the present proposed model replacement regulation now being submitted to the NAIC for adoption. It is identified as a "Comparative Information Form." The proposed model also includes one other major change from the June 1978 submission. It gives the existing insurer or its agent the option of using a fully-completed Comparative Information Form or a Policy Summary for the existing policy if it chooses to make a conservation effort.

Both changes deserve discussion; however, it appears advisable to do so along with all other major provisions in the proposal to give a better understanding of what the total proposed regulation will accomplish.

Operation of the Regulation

Perhaps the best way to begin is to describe the various agent and company functions that must take place in a replacement sale. They are as follows:

Before an agent takes an application for a policy that is to replace existing insurance, he or she must give the applicant the appropriate Notice Regarding Replacement (Exhibit A if another company's policy is being replaced; or B if the replacing company's policy is being replaced) and a Comparative Information Form (Exhibit D). The agent is responsible for including in the Comparative Information Form all of the information required concerning the proposed policy and only that information concerning the existing policy which is available to the agent from the existing policy. Agents will not insert dividend information on existing participating policies; nor outstanding policy loans, and in relatively few instances, interpolated cash values for existing whole life policies.

If more than one policy is to be replaced, a separate Comparative Information Form is to be provided for each policy, or separate information for each policy is to be provided in one Comparative Information Form. In addition, a summary of all the separate policy information must be furnished to the extent possible.

The Notice, Comparative Information Form, and any Sales Proposals used must be submitted with the application to the replacing insurer. (Copies of each are left with the applicant.) The replacing insurer must then verify the substantial accuracy of the information in the Comparative Information Form with respect to its policy and send a copy of the Form to the existing insurer within three working days from the date it received the application, or on the day it issues the proposed policy, whichever is sooner.

If the Comparative Information Form is not substantially accurate, the replacing insurer must obtain another form from its agent which is substantially accurate before it can begin to process the application for the proposed policy. (This form, like the original, must be signed by the applicant.) The three working days or policy issue date (if sooner) notification requirement, begins when the replacing insurer receives the substantially accurate Comparative Information Form.

If the replacing insurer provides a twenty-day money-back guarantee in its policy, it may issue the policy immediately together with a Policy Summary. A copy of the Policy Summary must be sent to the existing insurer within three working days from the date the policy is issued. (The Policy Summary consists of the same information and is in the same format as is required by the Model Solicitation Regulation, but it does not require the inclusion of interest-adjusted figures.)

If the replacing insurer does not provide a twenty-day money-back guarantee in its policy, it must delay issuing the policy for twenty days from the time it sends the existing insurer a copy of the Policy Summary for its policy. After the delay period is satisfied, the replacing insurer may issue the policy together with a Policy Summary to the insured/buyer.

Finally, the replacing insurer must record the replacement transaction in a replacement register, cross indexed by replacing agent and existing insurer to be replaced. It must also retain copies of the Notice Regarding Replacement, the verified Comparative Information Form, the Policy Summary and all Sales Proposals used. This material and the data recorded in the register must be kept for at least three years or until the conclusion of the next succeeding regular examination by the insurance department of the replacing insurer's state of domicile, whichever is sooner.

If the existing insurer or its agent makes an effort to conserve the existing policy, that insurer or its agent must either complete the portion of the Comparative Information Form that was not completed by the replacing agent (and correct any errors regarding the existing policy made by the replacing agent), or prepare a Policy Summary for the existing policy, and send it to the insured/buyer. The fully-completed Form or Policy Summary must be sent to the insured/buyer within twenty days from the date the existing insurer receives the Form from the replacing insurer. However, the existing insurer or its agent is not precluded from commencing its conservation effort prior to the time it sends the insured/buyer the completed Form or Policy Summary.

The existing insurer must send a copy of either the fully-completed Form or the Policy Summary for the existing policy to the replacing company within three working days from the date it sends whichever document it chooses to use in the conservation effort to the insured/buyer. It must also maintain copies of the Comparative Information Forms and Policy Summaries it receives from replacing insurers, as well as the fully-completed Forms or Policy Summaries it uses in its conservation efforts.

The proposed Regulation includes separate requirements for direct-response sales that are more responsive to this form of marketing.

If direct-response solicitation material does not encourage buyers to replace existing insurance, the insurer, when notified that a replacement will occur, need only mail the applicant the appropriate "Notice Regarding Replacement of Life Insurance" (Exhibit C) when it sends the policy. This approach is warranted since there is no pressure being put on the buyer to replace existing insurance, as might be the case when an agent is involved in the sale of a policy.

However, if the direct-response sales solicitation material illustrates the benefits of or encourages the reader to replace existing insurance, the insurer will be required to follow all of the disclosure procedures (except those concerning Comparative Information Forms) with which replacing insurers must comply. It was felt that this type of solicitation material would produce substantial motivation to an insured/buyer to replace existing insurance so as to warrant its being treated the same as where an agent encourages an insured/buyer to replace existing coverage.

(Note: If the applicant fails or refuses to identify the existing insured, the insurer need only mail the appropriate "Notice Regarding Replacement of Life Insurance" to the insured at the time it sends the policy. This approach is sound since the applicant is clearly making a voluntary decision not to provide the requested information.)

Significant Features of the Regulation

Having tracked the flow of agent and company functions and responsibilities in replacement sales under the proposed model, it may now be of benefit to focus on its significant features and briefly explain the reasons for including them in the proposal.

The following highlight the significant features of the proposed Regulation:

- Preliminary disclosure form presented to the insured/buyer at the time of sale – includes only information the replacing agent knows is true and accurate, but still makes the replacing agent accountable for recommending replacement.
- The replacing and replaced company must furnish information for their own policies to the insured/buyer.
- The replacing company must present information concerning its policy in the same format as is required by the Model Solicitation Regulation – dovetails the two regulations. The existing company has the alternative of fully completing the Comparative Information Form or furnishing the information in the same format as is required by the Model Solicitation Regulation.
- The replacing company must notify the existing company within three working days from the receipt of the application.
- The replacing company must provide a twenty-day money-back guarantee or delay issue for twenty days.
- Broadened definition as to what constitutes replacement.
- The replacing and replaced companies must exchange disclosure documents each furnished the insured/buyer.
- Institutes clearer standards for agent compliance.
- Establishes register to monitor replacement activity.

The above features and the main reasons they are included in the proposal are described in more detail below.

The replacing agent is required to put only that information he or she is absolutely sure of in the Comparative Information Form. This preliminary disclosure is buttressed by the requirements that the companies will be obligated to provide the insured/buyer with data concerning the replacing policy and the policy to be replaced. The replacing insurer must furnish the buyer with information for its policy; and the existing insurer, if it makes an effort to conserve its policy, must provide comparable information to its insured.

These two features will assure that only accurate information is given to the insured/buyer. They will not obstruct the insured/buyer's ability to get insurance protection, which is important since many replacement sales result in an increased face amount of insurance being placed on the insured's life. Also, these features should encourage agents to admit when they are replacing and to comply with the requirements of the regulation.

The disclosure form which the replacing company must use is the Policy Summary disclosure document required under the Model Solicitation Regulation. This requirement dovetails the two regulations. However, furnishing interest-adjusted index figures is not required by the proposed Model Replacement Regulation. The interest-adjusted method or any other cost comparison method thus far developed should not be used to compare dissimilar policies. Most replacement transactions would involve the comparison of dissimilar policies. If such comparisons were made, they could mislead the insured/buyer.

The existing company is allowed the option to make a conservation effort with either a fully-completed Comparative Information Form or a Policy Summary for the existing policy. If a Policy Summary is used, its contents and format must be the same as is required under the Model Solicitation Regulation, absent the requirement that interest-adjusted index figures be shown.

This feature of the proposed regulation includes the following principles:

- There is enough data in the Comparative Information Form to assure that if the existing company or its agent uses it to make a conservation effort that the insured/buyer will have sufficient information about both policies to make a decision.

- Companies or agents that cannot afford to produce Policy Summaries have a means with which to make an effective conservation effort at a reasonable cost. (If such a means were unavailable, they may not attempt to conserve -- which would deprive the insured/buyer from receiving more information about the replaced policy than the replacing agent would otherwise provide.)

- Companies and agents that desire to be more aggressive and responsive to attempted replacements of their policies will be able to use a more elaborate conservation document, i.e., the Policy Summary; and it too is subject to regulatory standards.

The proposed regulation requires that the replacing company notify the replaced company of the replacement within three working days from the time it receives the application from the replacing agent. The replacing company must also either include a twenty-day money-back guarantee in its policy or delay the issue of the policy for twenty days.

These features will give the existing company and its agent time to make an effective conservation effort. More importantly, they assure the insured/buyer of having ample opportunity to receive complete and accurate information from both companies and their agents before making a final decision whether to replace existing insurance.

The definition of what constitutes a replacement is significantly broadened under the proposed regulation, e.g., borrowing twenty-five percent (25%) of an existing policy's cash value to purchase new insurance constitutes a replacement. Expanding the definition does not necessarily imply that replacements are inherently wrong. It simply recognizes the need to require full disclosure whenever values in an existing policy are significantly affected by reason of the purchase of new insurance.

Similarly, the definition of existing life insurance brings cases on which a conditional receipt has been issued and policies that are still within a money-back guarantee period within the scope of the regulation. This provision has special significance in states which have not promulgated the Model Solicitation Regulation since it will enable the buyer to get pertinent information in comparable form from both companies when a competitive situation occurs.

Each company is required to give the other a copy of the Policy Summary and/or the Comparative Information Form it or its agent furnished to the insured/buyer. This allows all parties involved with the transaction to have the same knowledge of the basic information disclosed. And it helps pave the way for industry to better self-regulate replacement sales – which is the best form of regulation of this activity.

New features were added to improve the insurance department's enforcement capabilities. The proposed regulation includes a clearer standard for compelling agents to comply with its requirements or suffer severe penalty.

The existing replacement regulations typically state that the agent must know that a replacement transaction has or will take place. It calls for a subjective test determined by what is on the mind of the agent at the time the transaction occurs. The proposed regulation states that the agent know or should have known that replacement is involved. The "should-have-known" test will enable regulators to apply an objective standard of practice that a licensed agent must follow.

Another significant regulatory tool is the requirement that replacing insurers must maintain a replacement register, cross indexed by replacing agent and replaced insurer. The maintenance of this register will give companies and regulators the means to review the activities of agents who replace a significant amount of business. Specifically, it should assist in detecting and preventing "churning" of existing insurance by agents who change companies.

Conclusion

At this point in time, there is no solid evidence as to the extent of replacement activity. The primitive data that we have, plus our instincts, which are based on our companies' experience, tell us that the volume is relatively significant; that it is increasing; that most replacement sales are not admitted to or disclosed by the replacing agent; and that the existing Model Replacement Regulation and those patterned after it have failed to adequately protect the insurance-buying public.

Since most replacements involve one company replacing the insurance of another company, this fact has made the replacement issue a highly emotional one within the industry. The sentiment of the majority in the industry appears to be to outlaw or severely restrict replacement activity.

However, replacement transactions cannot be prohibited because of such legal principles as freedom of contract, and should not be prohibited in any event since there are instances where it may benefit an insured to replace an existing policy with a new one. Furthermore, an industry posture which attempts to make replacements a rigorous task by the imposition of artificial barriers could be interpreted as self-protectionist.

Focus must, therefore, be placed on the development and implementation of acceptable regulatory standards to govern replacement sales. These standards should include:

1. Assurance that the insured/buyer, who is giving up an investment in existing insurance, receives all relevant and useful information about the existing and new policies before making a final decision.

2. Means by which the replacing agent and replacing company can be held responsible and accountable for recommending a replacement sale.

3. Allowing the replaced agent and replaced company a reasonable opportunity to conserve its business.

These standards are the cornerstone from which the advisory committee sought to resolve the problems it perceives are associated with the replacement issue. And while no one company, or individual for that matter, may be totally satisfied with the proposed regulation being submitted, we believe it is an affirmative and workable solution that seeks to serve the consumers' interest first and deals reasonably with agents and all types of insurers in terms of the requirements and responsibilities it imposes on them. As such, the advisory committee recommends that the proposal now being submitted to the NAIC be adopted as the Model Replacement Regulation.

Carl T. Barnes, Policy Analyst, Kansas City Life Insurance Company; J. Stephen Beckman, President, United Investors Life Insurance Company; Jack E. Bobo, Executive Vice President, National Association of Life Underwriters; Ronald J. Doane (Chairman), Vice President, The Equitable Life Assurance Society of the United States; H. James Douds, General Counsel, National Association of Life Underwriters; Robert O. Fleckenstein, Assistant Vice President/Government & Industry

Relations, Metropolitan Life Insurance; H. Daniel Gardner, Assistant General Counsel, Northwestern Mutual Life Insurance Company; John Glover, Second Vice President, The Travelers Insurance Company; William F. Hannan, Associate General Counsel, The Prudential Insurance Company of America; Robert L. Hill, Counsel, Aetna Life & Casualty; Edwin F. Jackson, Executive Vice President and General Counsel, American Republic Insurance Company; John J. Jaskot, Senior Vice President, United Services Life Insurance Company; John M. Jex, Second Vice President/Governmental and Legislative Affairs, New York Life Insurance Company; Robert LeBeau, Vice President, National Association Term Life Underwriters; Don Leising, CLU, Security Mutual Life Insurance Co.; Frank McCormack, Senior Vice President, Fireman's Fund American Life Insurance Company; Michael D. Monette, Associate Corporate Counsel, Colonial Penn Life Insurance Company; John P. States, Associate Counsel, State Farm Life Insurance Company; Frederick H. Stone, Senior Vice President, General Counsel and Secretary, The Franklin Life Insurance Company of America; William M. Symon, Jr. (Secretary), Secretary and General Counsel, Old American Insurance Company; William R. Toler, Vice President/Operations, MFA Life Insurance Company.

REPORT TO THE NAIC BY THE INDUSTRY ADVISORY COMMITTEE ON POLICY LAPSATION

DECEMBER 1978

TABLE OF CONTENTS

INTRODUCTION

A. Formation of the Industry Advisory Committee

The genesis of this committee and its report on lapsation may be traced to October 2, 1973, when the National Association of Insurance Commissioners (NAIC) Task Force on the Proposed In-depth Study of the Life Insurance Industry isolated lapsation, its "causes, effects and cures"(1) as one of four areas for immediate study by the Life Insurance (C3) Subcommittee. A Policy Lapsation (C3) Task Force was appointed early in 1974 but was discharged by year-end 1974, since its report "concluded that there is very little of a definitive nature which the regulators can do that has a direct impact on lapse control."(2)

On November 5, 1975, then-President of the NAIC William H. Huff III (Iowa), in a speech to the industry, urged that lapse rates be disclosed by companies in their annual statements. This, he proposed, would be accomplished by the use of three separate formulas -- one for early duration policy lapses, one for longer duration policy lapses, and one for all lapses combined. A month later Commissioner Huff was appointed chairman of a new Task Force on Life Insurance Policy Lapsation. The Task Force was charged with the responsibility of identifying lapse problems and seeking solutions to these problems.

At the November 1977 meeting of the Life Insurance (C3) Cost Comparison Task Force,(3) to whom the study of lapsation had been assigned, a member of the Life Insurance Marketing and Research Association (LIMRA) was appointed to chair an Industry Advisory Committee. That committee was to identify the lapse problems in the industry and the solutions to these problems. The Task Force recommended that in addition to developing a lapse rate disclosure system, the Industry Advisory Committee should reply to the following global lapsation questions:

1. Is there a lapse problem?
2. How extensive is the lapse problem?
3. What are factors affecting persistency?
4. What effect do lapses have on rates for all other insureds?
5. What is the extent of injury to consumers where a high lapse rate exists?
6. What possible solutions may we find?

(1) NAIC Proceedings, 1974 Volume I, page 441.
(2) NAIC Proceedings, 1975 Volume I, page 697.
(3) The chairmanship of the Life Insurance (C3) Cost Comparison Task Force was then and continues to be held by Ms. Erma Edwards, CLU, FLMI, of the Nevada Insurance Division.

B. Industry Advisory Committee

In selecting Industry Advisory Committee members, effort was made to have representation from several segments of the industry. Members were selected for their expertise in the persistency area and were drawn from within a particular geographical sphere in consideration of the anticipated travel to committee meetings.

The organizational meeting of the Industry Advisory Committee was held at LIMRA in Hartford on January 31, 1978. At this meeting, the committee's charge was defined as follows:

1. The authorities want to be able to identify the companies that have excessive cash value plan lapse rates, so that they may challenge those companies to either improve or to explain why the level is justified. The committee's task is to develop a disclosure system that will avoid unfairness and misrepresentation of the data that the authorities are seeking.

2. The committee is to develop a report on lapsation in reply to the six global questions posed by the regulators.

The following full day committee meetings were held during 1978:

1. January 31 -- LIMRA, Hartford, Connecticut
2. March 28 -- LIMRA, Hartford, Connecticut
3. July 14 -- LIMRA, Hartford, Connecticut
4. September 29 -- New England Mutual Life Insurance Company, Boston, Massachusetts
5. October 25-26 (1½ days) -- Prudential Insurance Company of America, MidAmerica Home Office, Chicago, Illinois.

In addition to committee meetings, the committee was in constant communication through correspondence, telephone and written reports concerning its assignments.

Chairman Helen T. Noniewicz gave a progress report of the committee's activities at the May 1978 NAIC Life Insurance (C3) Cost Comparison Task Force meeting in Biloxi, Mississippi. A second report was given by committee member Bartley L. Munson in October, 1978, at the Task Force meeting in Indianapolis, Indiana.

C. The Report on Lapsation

This report on policy lapsation begins by addressing the questions posed by the NAIC, followed by a proposed lapse rate disclosure system, and ends with a summary of the entire report.

The report is based on ordinary life insurance and, therefore, excludes the following: group life, industrial life, credit life, and all annuity and health insurance.

Lapse, unless otherwise qualified, is defined to represent business voluntarily going off the books, with or without value, including the application of reduced paid-up or extended term options. Persistency is defined as the proportion of business remaining on the books after lapse occurs.

It may be noted that this report on lapsation is initiated from the viewpoint of the consumer. However, the committee tried to bear in mind that the report should be developed and drafted for the intended use of several audiences -- the consumers, the regulators, and the insurance industry.

D. Recommendations

The committee recommends that its report on lapsation be released for at least a six-month exposure period before the NAIC acts on it, with the understanding that the Industry Advisory Committee will remain as a committee until the NAIC takes the report under consideration. If the NAIC believes the proposed disclosure system might be appropriate, the committee recommends it be given thorough testing by selected companies before it is adopted. A subcommittee of the Advisory Committee could be appointed to work on details and direct this further evaluation.

Because of the extensive data processing procedures that must be established in order to comply with the proposed disclosure system, the committee recommends that a three-year implementation period be given from the time that the disclosure system may be adopted to its effective date.

E. Commentaries

The committee wishes to acknowledge that, in developing a lapse rate disclosure system, it is responding to a request made by the NAIC and not necessarily advocating such. A lapse rate disclosure system may result in a company's improved efforts to better fit its products to both the needs and means of the policyowners to whom it sells. However, in other cases, a disclosure system may result in lapse rate improvement because of a company's curtailment of marketing in particular segments of the population that traditionally experience high lapse rates, as in "inner cities" or to "blue-collar" markets and young adults. If a shift in markets results in segments of the population having life insurance less readily available, there may be social costs that will have to be borne and undesirable side effects (e.g. pockets of uninsured citizens might be fostered and a greater need for government plans

may be generated). These would be unintended results and should be guarded against.

The insurance industry's interest, involvement and activities in the area of lapsation made possible the committee's prompt response to the NAIC charge. It may be stated, however, that the report voices the opinions of the committee members and not necessarily the companies that they represent or the opinions of all conceivable segments of the industry.

The committee wishes to note the special contribution of the following nonmembers who attended committee meetings and acted as advisors to the group: Richard V. Minck, FSA, MAAA, Executive Vice President, Government Relations Division, American Council of Life Insurance; E. J. Moorhead, FSA, MAAA, Consultant to the NAIC; and Elizabeth Tovian, Assistant Vice President -- Financial Research, Life Insurance Marketing and Research Association.

F. Industry Advisory Committee to the NAIC On Policy Lapsation

Helen T. Noniewicz -- Chairman
Assistant Vice President --
Manpower and Market Research
Life Insurance Marketing and
Research Association

Howard D. Allen, FSA, MAAA
Senior Vice President --
Technical Services
(Alternate member:
Jan C. Brown, FSA, MAAA
Associate Actuary)
John Hancock Mutual Life
Insurance Company

Wilson L. Forker, CLU
Second Vice President -- Marketing
(Alternate member:
Thomas J. Young, FSA
Actuarial Vice President)
Equitable Life Insurance Company
of Iowa

William M. Snell, FSA, MAAA
Associate Actuary
The Northwestern Mutual Life
Insurance Company

Roger Stroud, CLU
Director, Sales Development
IDS Life Insurance Company

Bert van Uitert, FLMI
Second Vice President --
Research and Planning
New England Mutual Life
Insurance Company

Julius Vogel, CLU, FSA, MAAA
Senior Vice President and
Chief Actuary
(Alternate member:
I. Edward Price, FSA, MAAA
Vice President and Associate
Actuary)
The Prudential Insurance
Company of America

Bartley L. Munson, FSA, MAAA
Vice President and Actuary --
Insurance Products
Aid Association for Lutherans

Frank Zaret, FSA, MAAA
Actuary
Metropolitan Life Insurance
Company

W. Keith Sloan, FCA, MAAA, FLMI
Assistant Actuary
Lumberman's Mutual Casualty
Insurance Company

CHAPTER I

IS THERE A LAPSE PROBLEM?

The charge to this committee understandably begins with the question:

"Is there a lapse problem?"

One can surmise that there must be, in the eyes of the NAIC Life Insurance (C3) Cost Comparison Task Force, for they charged the committee with five more questions, each flowing in sequence from an affirmative answer to the immediately preceding one. Still, this is the initial question to be answered.

Although this type of question is difficult to answer, categorically, it is desirable to attempt an explicit response. The alternatives are either a) to implicitly assume there is a problem, by plunging into our analysis of causes and solutions, or b) to assume that there is no problem, by blithely dismissing our charge. We must reject both of those alternatives.

Let us at the outset state that, yes, as a committee we feel there is a lapse problem, in the sense that: we wish fewer policies terminated in lapses; we recognize those harmed by lapsation include the buyer (lapser, persister), industry, agent, company and beneficiary; and we believe improved persistency, to the advantage of all, can be achieved, although not easily. This subject is very complex, sometimes yielding to temptingly simplistic -- and dangerous -- answers and "solutions". This will be shown as this report progresses. But, yes, we believe there is a "problem", in the wording of our charge, and this report is intended as a helpful contribution to its solution.

Let us, then, share our reasons for answering a "yes" to the first question.

It is instructive to observe: a) who seems to have shown an interest in this subject; b) to what extent they seem to have shown concern or believe there is a problem; c) what that problem is thought to be; and d) what evidence is cited. These aspects are discussed for each of six groups of interested persons, in no particular order but consisting of:

1. Insurance Industry
2. National Association of Insurance Commissioners
3. U.S. Senate's Hart Hearings of 1973-4
4. Federal Trade Commission
5. Individual Critics
6. Individual Policyholders

1. Insurance Industry

The industry, and various related research bodies, have long had an interest in the lapse subject. A few examples, from various quarters, will illustrate.

a. The ACLI (American Council of Life Insurance)

The ACLI and its predecessor organizations have long monitored lapse rates and assisted companies in improving those rates. Typical of its concern is this comment from the book of statistics -- including lapse data -- published annually by the ACLI:(1)

> "The life insurance business seeks to minimize the lapsing of policies. For example, the training of agents focuses on realistic identification of the life insurance needs of clients and the careful analysis of the use of family income for protection purposes. Since there is a higher termination rate of policies on which loans are outstanding, companies urge that loans be used only in genuine financial emergencies, and that they be promptly repaid.
>
> "Many companies offer policyholders time after delivery of the policy in which to consider whether to keep the policy. These companies will refund the premium in full if the policyholder decides not to keep the policy within the prescribed time."

b. Individual Companies

More will be said later about the efforts of individual companies to improve persistency. Here suffice it to state

---

(1) Life Insurance Fact Book '77, page 53.

those efforts are evidence of a sincere feeling that if it is not a lapse "problem" then it at least is a situation worth attempting to improve. Many company resources -- people and dollars and programs and effort --are committed to lowering lapse rates. Examples and some comments are shared later in this report.

c. LIMRA (Life Insurance Marketing and Research Association)

Much of the data used in our report is from LIMRA studies and analyses. Their interest in and concern about lapse rates has long been recognized; their early identification by the NAIC as an important resource is evidence of this.

Indicative of their concern and awareness of the situation is this introduction to a recent report on the subject:(1)

> "The termination of life insurance policies prior to maturity or death of the insured, generally referred to as lapsation, is a topic of major concern to several groups.
>
> "The insurance industry is disturbed about the effects of lapsation on cash flow and product cost.
>
> "The consumerist movement is alarmed over the potential financial losses suffered by early termination policyholders, and the added cost lapsation causes on all life insurance premiums.
>
> "Politicians have seized upon the lapsation issue. Senate subcommittee hearings have been held, data collected and analyzed, and members have issued public statements emphasizing their concern over the high incidence of early lapsation."

Of their many research efforts, these are current studies dealing directly with policy lapses:

- Long-Term Lapse Study
- Early Lapsation -- Does the Economy Play a Role?
- Indicators of Short-Term Lapsation -- A Comparative Study
- Early Lapsation -- Do the Rates Differ by Company Category

---

(1) Short-Term Lapse Rates, A Comparative Study, LIMRA, August 1977, page 1.

- United States and Canadian 13-Month Ordinary Lapse Survey
- United States and Canadian Persistency Studies
- Predictive Study of Early (within 25 months) Lapsation
- Study of Replacement Activity
- Not-Taken Policies and the Free-Look Privilege

Clearly there exists an interest in what might be inferred to be a "problem".

d. Society of Actuaries

Unlike studies of mortality, for example, studies of lapsation have not been a formal part of the Society's ongoing research efforts, largely because such organizations as LIMRA have done the job. However, lapses are of great interest to actuaries, and there have been occasional expressions of concern in the literature.

Perhaps Norman F. Buck, in the first sentence of his paper "First Year Lapse and Default Rates"(1), said it best:

> "Since lapse rates will probably always be with us, it behooves us to try to minimize or postpone them or adjust to them as best we can."

2. National Association of Insurance Commissioners

Undeniably, the NAIC has long held an interest in the subject. In more recent history, the appointment of this Industry Advisory Committee indirectly derives from an October 2, 1973 report and traces through in this fashion.

a. The initial reference is this excerpt from the October 2, 1973 report of the Task Force on the Proposed In-Depth Study of the Life Insurance Industry(2):

> "Although the Task Force recognizes that many problem areas could be identified which are not currently under study by the NAIC and which could probably be included in a list of subjects for study, we have isolated four areas of concern which we believe should receive the immediate attention of the Life Insurance (C3) Subcommittee. The studies which we propose are as follows:

---

(1) Transactions of the Society of Actuaries, Volume XII, page 258.
(2) NAIC Proceedings, 1974 Volume I, page 440.

> "1. A study of causes, effects and cures for life insurance policy lapses. Consideration should be given to the role of (sic) the type of policy, marketing system, agent's compensation, amount of coverage, amount of premium and replacements play in high lapse rates.
>
> "2. . . . ."

This suggestion revealed an awareness of some of the factors affecting lapsation.

b. In a June 3, 1974 report of the Life Insurance (C3) Policy Lapsation Task Force(1), it was stated that five questions were appropriate areas for exploration. (These same five questions are questions 2-6 in the actual charge this Industry Advisory Committee received.) That report went on to recognize the need for data, much of which already existed, and cited some further factors to be recognized:

> "The Task Force feels that initial steps should include assembling from all trade associations, insurance companies, and other sources any previous studies and materials on the subject available. It is hoped that these studies will not only include studies on lapse in the early duration (two years or less) but also in later durations (after two year). Likewise, there needs to be material available comparing lapses as related to active agents' insureds versus 'orphaned' policyowners.
>
> "It is felt that there is a great interrelationship between the work of this Task Force and those studying non-forfeiture values and agents' compensation."

c. In a December 2, 1974 report(2), that same task force added some further insights into what they felt was a lapse problem:

> "Manual Cueto of the New York Department reminded us of the fact that changing economic conditions, over which insurance regulators and industry have no control, have a serious impact on later year lapsation . . . .

---

(1) NAIC Proceedings, 1974 Volume II, page 520.
(2) NAIC Proceedings, 1975 Volume I, page 697.

"In Executive Session it was concluded that there is very little of a definitive nature which the regulators can do that has a direct impact on lapse control. However, there are many things which have an indirect effect . . . .

"The task force expressed concern that if companies are offering specially designed policies for specific markets, they may leave a gap which could result in federal intervention to provide for the needs of people who otherwise are not being sold insurance. This gap would result from companies eliminating policies with higher lapse potential and thus removing certain products from the market. These are usually policies bought by those individuals more prone to lapse."

d. The December 9, 1975 report of the Life Insurance (C3) Subcommittee(1) reported:

"Commissioner Huff was appointed as Chairman of a new task force on life insurance policy lapsation. The task force was charged with the responsibility of identifying specific problems involved and seeking solutions to the problem of life insurance policy lapsation."

e. On June 8, 1976, the Life Insurance Policy Lapsation (C3) Task Force(2) reported:

". . . LIMRA has recently greatly expanded its surveys of life insurance lapsation in an attempt to identify characteristics of policyholders, policies and sales techniques which result in above average lapse rates. The results of this initial research stage, which involves identifying the problems, will dictate the nature of the solutions which we will propose.

"Although this task force will attempt to discharge its responsibilities in a timely fashion, the complex nature of the problem does not lend itself to a hasty solution."

---

(1) NAIC Proceedings, 1976 Volume I, page 521.
(2) NAIC Proceedings, 1976 Volume II, page 557.

f. On November 9-10, 1977, the Life Insurance (C3) Cost Comparison Task Force met to discuss the responsibility to pursue the policy lapse question it recently had been given. Its report on December 7, 1977 to the Life Insurance (C3) Subcommittee indicated:(1)

> "The original Task Force on Policy Lapsation was given the charge to respond to five specific questions, as follows:
>
> "1. What is the extent of the problem of lapsation?
>
> "2. What is the source of lapsation?
>
> "3. What is the effect of early lapsation on rates charged with (sic) continuing insureds?
>
> "4. What is the extent of financial loss to consumers where high lapse rates exist?
>
> "5. What feasible solutions can be found?
>
> "The task force reviewed the questions and feels they form a sound basis for a beginning study. Additionally, it was suggested the first question to be considered should be to identify whether or not a lapse problem exists. The suggestion was accepted and the five (sic) (six) questions will be the subject of the study. An industry advisory committee, chaired by (a member of) the Life Insurance Marketing (and) Research Association (LIMRA) will be appointed to begin the study. The advisory committee was requested to provide a progress report to the task force for review prior to the June 1978 meeting and to consider a possible final report prior to December 1978."

Through this chain of reports, it's clear the NAIC perceived: a problem exists; the identification of the problem and its solutions(s) are not easily achieved; and the solution(s) nonetheless should be persistently pursued.

---

(1) NAIC Proceedings, 1978 Volume I, page 474.

3. U.S. Senate's Hart Hearings of 1973-4

The hearings on the life insurance industry before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary of the U.S. Senate -- commonly called the Hart Committee, after the late Senator Hart (D - Michigan) who chaired it -- focused on many subjects related to the selling of life insurance and, particularly, its cost and understandability to the buyer. Among these was the subject of policy lapsation. It appeared in more than one questionnaire and in much of the correspondence and discussion between the committee and the insurance industry.

Question 31 of that investigation's Life Insurance Questionnaire No. 1 asked many insurers for the "first year lapse rate for 1972 based on the LIAMA formula".(1) And question 33 asked for probabilities of "withdrawal" as well as death based on a male issue age 35. The questions and the results for the responding companies (57 for question 31, 63 for question 33) are attached as EXHIBIT 1 at the end of this report.

Mr. Alfred G. Whitney, retained as Statistical Consultant to the Hart Committee(2), indicated: "The spread in (first year LIMRA lapse) rates reported was very great, ranging from 5 to 49 percent." In his testimony, Mr. Whitney went on to state:

> "In conclusion, I don't think it's necessary to belabor the point that a high rate of early lapsation is a serious problem and is undesirable, except in a few very obvious cases.
>
> "A lapse in general represents a failure of a plan and a high early lapse rate indicates a failure which is a serious loss to everyone concerned . . . .
>
> "Appropriate sales should not lapse at the high rate that we find in these data."(3)

Senator Hart expressed his concerns about high early lapse rates:

> "2. Policyholders are wasting millions of dollars yearly because they are terminating (or lapsing) their cash value policies too early.

---

(1) which formula defines a lapsed policy as one that fails to pay premiums for the first 13 months of the policy's life.

(2) and retired Director of Market Research and Statistical Surveys at LIAMA (now LIMRA).

(3) Hart hearings, Part 4, July 16, 1974, page 2253 ff.

> "For example, policyholders who bought cash value policies from four of the large New York companies in 1971 lost nearly $25 million when they lapsed those policies within 13 months after purchase.
>
> "Hart said data supplied by the companies shows it is relatively common for one out of three policies to lapse within 13 months -- whether the company is large or small.
>
> " 'This indicates that consumers may be buying what they don't need or can't afford because they don't understand,' Hart said."(1)

In the July 16, 1974 hearings, at which time much data were put into the record, Senator Hart stated:

> "Last year . . . we heard a great deal about the costs to consumers from the rapid agent turnover in companies, and from the high ratio of policies allowed to lapse in the first several years after the purchase."(2)

In his presentation of the "Consumer Insurance Information and Fairness Act", which resulted from the hearings and collected data, the Senator also stated, after quoting several high lapse rates:

> "Dropping a policy in its infancy is expensive for consumers . . . . One study showed that customers of 31 companies who bought cash value policies in 1971 but dropped them within 13 months sacrificed about $55 million in premiums -- after discounting what they would have paid for reasonable term insurance. And . . . lapses also are expensive for the company and the remaining policyholders.
>
> "Why are there such high early lapse rates, and who and what are to blame?
>
> "According to constructive critics and students of this industry, inappropriate sales and even 'deceptive sales practices which are a national disgrace' are the leading causes . . . .

---

(1) March 5, 1974 press release from Senate Antitrust and Monopoly Subcommittee.
(2) Hart hearings, Part 4, July 16, 1974, page 2217.

> "I am not alone in these observations. Responsible people in the industry and State insurance departments share my concern over high early lapse rates . . . ."(1)

Senator Hart then introduced bill S.2065 entitled the "Consumer Insurance Information and Fairness Act." Relevant to our charge, it is worth noting that it would require the company to disclose to the buyer the LIMRA 13-month lapse rate on its total sales of the most recent complete calendar year for which data are available.

It seems clear that the Hart Committee, its staff and advisors were very interested in the lapse situation; they believed there was a problem; the problem was thought to relate at least partially to the manner and quality of the sales process; data from insurance companies showing widely disparate lapse rates -- some very high -- were unrefuted, though admittedly in need of careful interpretation; and one solution was considered to be some type of lapse rate disclosure.

4. Federal Trade Commission

The FTC initiated an investigation of the life insurance industry in December of 1976, to determine "if adequate cost information was being given to prospective life insurance purchasers." This investigation has broadened to look at several aspects of the marketing of life insurance, utilizing some research projects and a lengthy questionnaire sent to "about 100 life insurance companies selected on the basis of size."(2)

The questionnaire contains a question intended to elicit lapse data on a sampling of 100 policies for each of the several types of policies commonly sold by the company. It also asks for essentially the LIMRA 13-month lapse rate on 1976 sales of the same common plans of insurance.

It is not yet exactly clear what the concern of the FTC is with regard to lapses nor what they will do with the data. Their questionnaire is self-acknowledged as at least partially a follow-up to the Hart investigation; from that we may gain some insight into the future course of the FTC concern in this regard.

---

(1) Congressional Record, Vol. 121, No. 106, July 8, 1975 page S11976.
(2) Letter of FTC to Government Accounting Office, January, 1978.

5. Individual Critics

Articles and books critical of the life insurance industry sometimes include complaints about policy lapse rates. This quote is the type of comment sometimes read:

> "It seems to me that (the above-described) record of terminations with its clear reflection of dissatisfaction on the part of policyowners is far more significant than the glowing sales reports . . . .
>
> "When $1 worth of old insurance is given up for every $2 worth of new insurance written, isn't something radically wrong somewhere?"(1)

Typically, such complaints are not well-defined and defensible. The reader often has little or no feeling for the source of such comments, let alone a basis for validating the data. When the basis is defined, as in the cited instance, the conclusion or at least the inference is not valid, even though the arithmetic may be correct -- as it appears to be in the cited instance.

Authors and other critics at times may be pointing out valid evidence of a lapse problem. But their sources, data and methodology frequently leave something to be desired; other, more useful, observations come from the other sources cited on this list.

6. Individual Policyholders

They very rarely, if ever, comment upon the matter of policy lapsation, at least from a collective view. They are in no position to feel the impact of the collective effect of "high" or "low" rates of lapsation. True, there is an effect on the individual, whether lapser or persister (as discussed later in this report), but it is not discernible by the individual policyholder.

An individual policyholder can notice, obviously, the effect of his or her own lapse. Such a policyholder may comment upon the reason(s) for the lapse, though this is rarely volunteered. He or she does somewhat more often note the amount paid, if anything, at the time of lapse, though that too is very infrequently commented upon.

Individual policyholders are not a source of input regarding whether there is felt to be a lapse problem. Nor should they be expected to be. We are addressing with our charge the matter of general levels of lapse rates, of patterns, of experience with groups of policies and their attendant characteristics. While the

---

(1) What's Wrong With Your Life Insurance, Norman F. Dacey, page 88.

whole may be the sum of the parts, there is no reason to expect any part to be able to describe or form an opinion about the whole. And, indeed, parts provide little useful input to us as to whether a problem exists.

In summary, there has been a long-time interest in the subject of policy lapsation by many persons. Their interest has not always explicitly labeled the situation a "problem", but concern about the causes and effects of unnecessarily high lapse rates has been rather consistently evident. The appointment by the NAIC of this Industry Advisory Committee thus seems an appropriate and timely opportunity for the industry to express itself on the subject and assist the regulators to represent responsibly the interest of the policyholders.

How does the committee itself answer the question other than with a cautious "yes, there is a lapse problem"? We are content to pursue "facts for appearances and demonstrations for impressions"(1) if for no other reason than several important groups seem to believe there is, indeed, a problem. But we, too, believe there is reason for concern and that something can be done to improve the situation.

The exposition of our beliefs as to the nature of the problem and its solutions will be developed in the remainder of this report.

No less an observer than the late Senator Hart said that ". . . no industry has greater statistics, unless it's baseball, than the insurance industry."(2) Were we to gather all relevant data, without attempting to produce any new, both the committee and the readers of this report would be inundated. Throughout we've tried to glean only the most important and to refer to sources for more detail, where it's desired.

One general caution must be stated. Let us continue to realize that while we desire a reasonably low lapse rate, we must not delude ourselves that the total lack of lapse is either possible or desirable. It is neither. If each life insurance sale were perfectly fitted to the needs of the insured, and if those needs never subsequently changed, and if only death protection and no ancillary benefits for savings dollars and their corollary benefits were available, and . . . well, then zero lapses might be possible and desirable. Because those conditions are not reality, let us heed Robert Browning:

---

(1) From "The work of science is to substitute facts for appearances and demonstrations for impressions" by Ruskin, adopted as the motto of the Society of Actuaries.
(2) Hart hearings, Part 4, July 16, 1974, page 2256.

"The common problem, yours, mine, everyone's,
Is -- not to fancy what were fair in life
Provided it could be, -- but, finding first
What may be, then find how to make it fair
Up to our means."(1)

CHAPTER II

HOW EXTENSIVE IS THE LAPSE PROBLEM?

The preceding chapter traced the events that resulted in the committee's cautious acknowledgement of a lapse problem. Germane to this acknowledgement is the discussion of the extent of the lapse problem. This will be done by studying industry trends of lapsation, recognizing the differences among individual company lapse rates, and interpreting individual company lapse rates.

A. Industry Trends of Lapsation

The industry-generated data which became central to the issue of high rates of early lapsation during Senator Hart's hearings are the less-than-two-year voluntary termination rates currently being reported by the American Council of Life Insurance (ACLI) in their annual publication, The Life Insurance Fact Book(2). The ACLI series has been used by some to indicate that early lapse rates for the industry have more than doubled in the past 25 years.

However, the LIMRA 13-Month Ordinary Lapse Survey has shown no such long-term rising trend in early lapse rates. The LIMRA 13-month lapse rate(3) series begins in 1961, since previous LIMRA studies were based on a first- and second-year rate. The 13-month lapse rate has reflected a trend that is cyclical in nature, with the 1977 rate 4.3 percentage points lower than that in 1961 (14.7 percent versus 19.0 percent). The LIMRA series suggests that the industry's rate of lapsation has been held at approximately the same level over a 17-year period and that the rate may actually have improved.

The two lapse rate series are shown in TABLE 1 and in GRAPH 1.

---

(1) Robert Browning's "Men and Women. Bishop Blougram's Apology".
(2) The series was introduced in the 1975 issue of that book.
(3) The 13-month lapse rate is that percent of business which fails to pay any premium in the second policy year.

TABLE 1

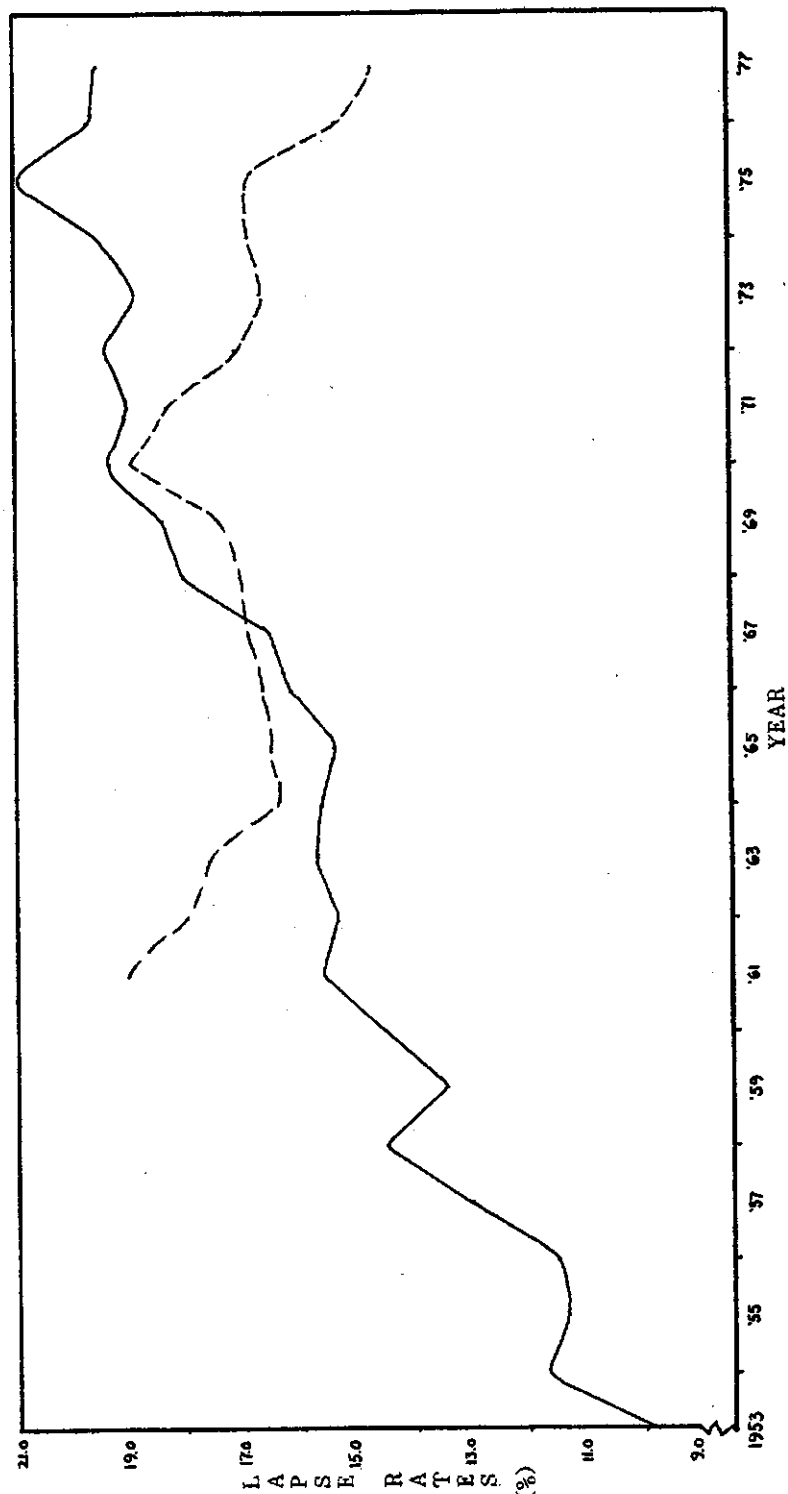
Early Lapse Rates

Year	ACLI: Lapses Within First Two Years	LIMRA: Lapses Within First 13 Months
1953	9.9%	NA
1954	11.7	NA
1955	11.4	NA
1956	11.5	NA
1957	13.0	NA
1958	14.5	NA
1959	13.5	NA
1960	14.5	NA
1961	15.6	19.0%
1962	15.3	17.9
1963	15.7	17.6
1964	15.6	16.4
1965	15.4	16.5
1966	16.2	16.6
1967	16.5	16.8
1968	18.0	17.0
1969	18.3	17.4
1970	19.3	18.9
1971	19.0	18.3
1972	19.3	17.1
1973	18.8	16.7
1974	19.5	16.9
1975	20.9	16.9
1976	19.7	15.3
1977	19.5	14.7

NA = Not Available

GRAPH 1

Early Lapse Rates



Key: _____ ACLI less-than-two year voluntary termination rates of ordinary life

– – – – – LIMRA 13-month ordinary life lapse rates

Because of the divergent trends of the two series of early lapse rates, LIMRA made a study(1) to define the causes of divergence. The results of the study may be summarized as follows:

1. The ACLI lapse rate is a ratio of a) first and second year ordinary policies lapsed or surrendered during one calendar year to b) the mean number of first and second year policies in force during the year. In essence, this ratio may represent anywhere from 50 percent to 70 percent of a first and second year true probability lapse rate(2). The LIMRA lapse rate, on the other hand, was shown to estimate the probability of the face amount of insurance lapsing within its first 13 policy months. The dissimilarity of the two formulas should produce different levels of lapse for any one year; however, the trends of lapse rates should parallel each other over a period of time.

2. The basis of measurement of each rate (number of policies in the ACLI rate, face amount in the LIMRA rate) was judged to have a relatively insignificant effect on the divergence of the trends over time.

3. A somewhat greater impact, but still relatively minor, was attached to the difference in the exposure periods: LIMRA measures 13-month lapsation; ACLI measures 24-month lapsation.

4. Although the study was unable to quantify the impact of data-related errors on the trend of the ACLI series, the assessment was that the estimates generated by the ACLI have introduced some upward bias into the growth rate of the series.

5. Almost all of the responsibility for the divergent trends fell upon the rapidly increasing number of smaller companies included in the ACLI aggregate rates. In 1955, the ACLI surveyed 152 out of 1,107 legal reserve life insurance companies selling in the United States. In 1975, 522 companies were included in the study, from 1,790 companies conducting business within the United States. The 370 companies added to the ACLI survey since 1955 are typically smaller companies than the original 152 companies in the 1955 survey; and the persistency of insurance issued by those smaller companies has been

---

(1) Short-Term Lapse Rates, A Comparative Study, August 1977, Economic and Market Research Unit, LIMRA.

(2) A rate that reflects the probability that policies issued within a given time period will terminate prior to two full years of being in force.

shown to be inferior to that of the older, larger companies. Most of these 370 companies added to the ACLI series during the 1955-1975 years had been conducting business prior to 1955. Had these companies been included in the survey from 1955 on, the study concludes that the ACLI results would exhibit a trend similar in nature to LIMRA's 13-month lapse trends(1).

Although the ACLI had not retained past data used in their series, historical data on a constant group of 14 large companies are available from 1955 through 1975. Thirteen of these companies have been included in the LIMRA survey since 1961 and the 14th company entered the LIMRA survey in 1968. TABLE 2 presents the ACLI and LIMRA lapse rates for the 13-company group from 1961 through 1975, and for the 14-company group from 1968 through 1975(2). In order to facilitate recognition of the trends and to permit easy comparison between the ACLI and LIMRA results, indices have been included in TABLE 2. As the table indicates, the constant group of large companies has shown similar variations in both the ACLI and LIMRA series -- i.e., results are fairly constant over a period of years rather than the continually increasing rates of the ACLI published series.

In summation, when lapse rates are studied for a constant group of companies, we see that lapsation has not more than doubled in the past 25 years, as some believe. Instead, the early lapse rates have been fairly stable, with some cyclical variations; and the industry currently is experiencing lower lapse rates for ordinary business than have been experienced at times in recent decades.

B. Individual Company Lapse Rates

We have heretofore spoken in terms of averages for aggregated groups of companies. These averages provide a very useful measure but do mask the extent of the differences in the individual company lapse rates within the group.

As an example, GRAPH 2 shows a tabulation of the LIMRA 13-month ordinary life lapse rates for 1977(3), covering 91 United States ordinary(4) companies or ordinary departments of combination com-

(1) The LIMRA survey has fluctuated between 92 and 93 companies since the study started in 1961.

(2) Short-Term Lapse Rates, A Comparative Study, August 1977, Economic and Market Research Unit, LIMRA, page 33.

(3) United States and Canadian 13-Month Ordinary Lapse Survey, Year 1977: I/R Code 63.70.

(4) Companies or departments issuing only premium notice business.

TABLE 2

Comparative Lapse Rates -- LIMRA and ACLI
Constant Groups of Companies

	13 Companies				14 Companies			
	ACLI		LIMRA		ACLI		LIMRA	
Year	Rate	Index	Rate	Index	Rate	Index*	Rate	Index
1961	14.8%	100.0	19.9%	100.0	13.3%	89.9%	NA	NA
1962	14.0	94.6	18.7	94.0	13.0	87.8	NA	NA
1963	13.6	91.9	18.5	93.0	13.0	87.8	NA	NA
1964	12.5	84.5	17.1	85.9	12.6	85.1	NA	NA
1965	12.5	84.5	17.1	85.9	12.5	84.5	NA	NA
1966	13.0	87.8	17.6	88.4	13.1	88.5	NA	NA
1967	13.7	92.6	17.7	88.9	13.6	91.9	NA	NA
1968	14.2	95.9	17.0	85.4	14.8	100.0	20.8	100.0
1969	15.2	102.7	18.1	91.0	15.1	102.0	21.9	105.3
1970	15.7	106.1	19.4	97.5	15.9	107.4	22.6	108.7
1971	14.8	100.0	18.9	95.0	15.1	102.0	22.1	106.3
1972	14.7	99.3	18.9	95.0	15.0	101.4	21.9	105.3
1973	14.0	94.6	18.3	92.0	14.3	96.6	21.9	105.3
1974	14.6	98.6	17.7	88.9	15.4	104.1	21.4	102.9
1975	14.8	100.0	18.6	93.5	15.2	102.7	20.8	100.0

*1968 has been set equal to 100.0 to allow comparability with the LIMRA trend.

panies. The individual company lapse rates range from 6.2 percent to 34.6 percent, with a weighted average rate of 14.7 percent.

A similar set of data for ten United State combination(1) companies or departments showed individual company ordinary life 13-month lapse rates ranging from 18.6 percent to 51.3 percent, with a weighted average rate of 24.6 percent.

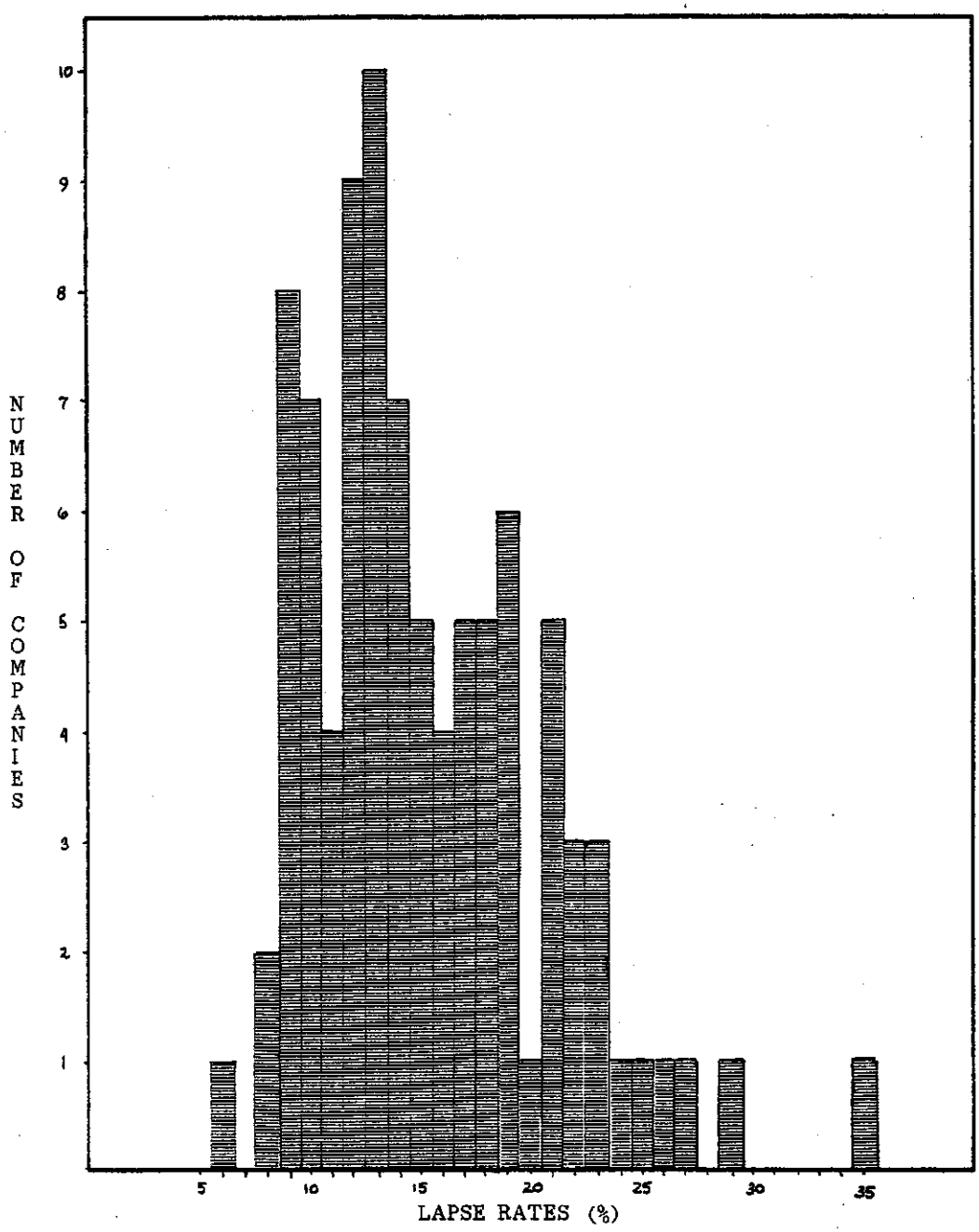
The ranges in both groups of companies most probably would be wider if all companies in the industry were observed.

A graphic comparison of how lapse rates are scattered, by company, beyond the first year may be observed in GRAPHS 3 and 4. Data in

(1) Companies or departments issuing debit ordinary business and premium notice business.

GRAPH 2

LIMRA 13-Month Ordinary Life Lapse Rates
Year 1977



these graphs are derived from two sources: data from the Hart Committee hearings(1) and data from the LIMRA long-term lapse studies(2). The figures from the hearings are presented as vertical bars for policy years 1, 2, 10 and 20 and are derived from the "Summary of Analysis of Terminations by Lapsation Based on a Radix of 100,000 Straight Life Insurance Policies to Males Age 35." The x's on each bar represent the highest lapse rate, the lowest, and a weighted average. The results of the 1974 LIMRA long-term lapse study produce the year-by-year curve; lapse rates are based on sales to adults in the 35-39 age at issue classification(3). GRAPH 3 represents performance for individual policy years, while GRAPH 4 represents the cumulative lapse rates. These graphs indicate that the highest lapse rate in the first policy year is almost double the average rate for all companies combined and that this kind of relationship holds for subsequent policy durations. It is this wide variation among individual company lapse rates that is of concern to all.

C. Interpretation of Individual Company Lapse Rates

At this point, the committee wishes to caution that while there may be noticeable differences in lapse rates among companies, those differences may or may not be significant, depending on the underlying situation prevailing in each company. The "underlying situation" may pertain to a company's markets of operation, to the characteristics of the business it writes, and/or to the age of its inforce business. The following two hypothetical examples serve to explain the caution that must be applied in the interpretation of individual company lapse rates.

Situation 1

A lapse rate for all durations combined is 6.6 percent for company ABC while company XYZ's comparable rate is 14.7 percent. On the surface, it may appear that company XYZ has a lapse problem, at least relative to company ABC. However, further study indicates that company ABC is an old, established company while company XYZ has been in existence less than two years. Comparing each company against industry norms based on duration of business comparable to its own establishes the fact that each company has exactly average persistency -- i.e., company ABC was not superior to company XYZ in its persistency experience.

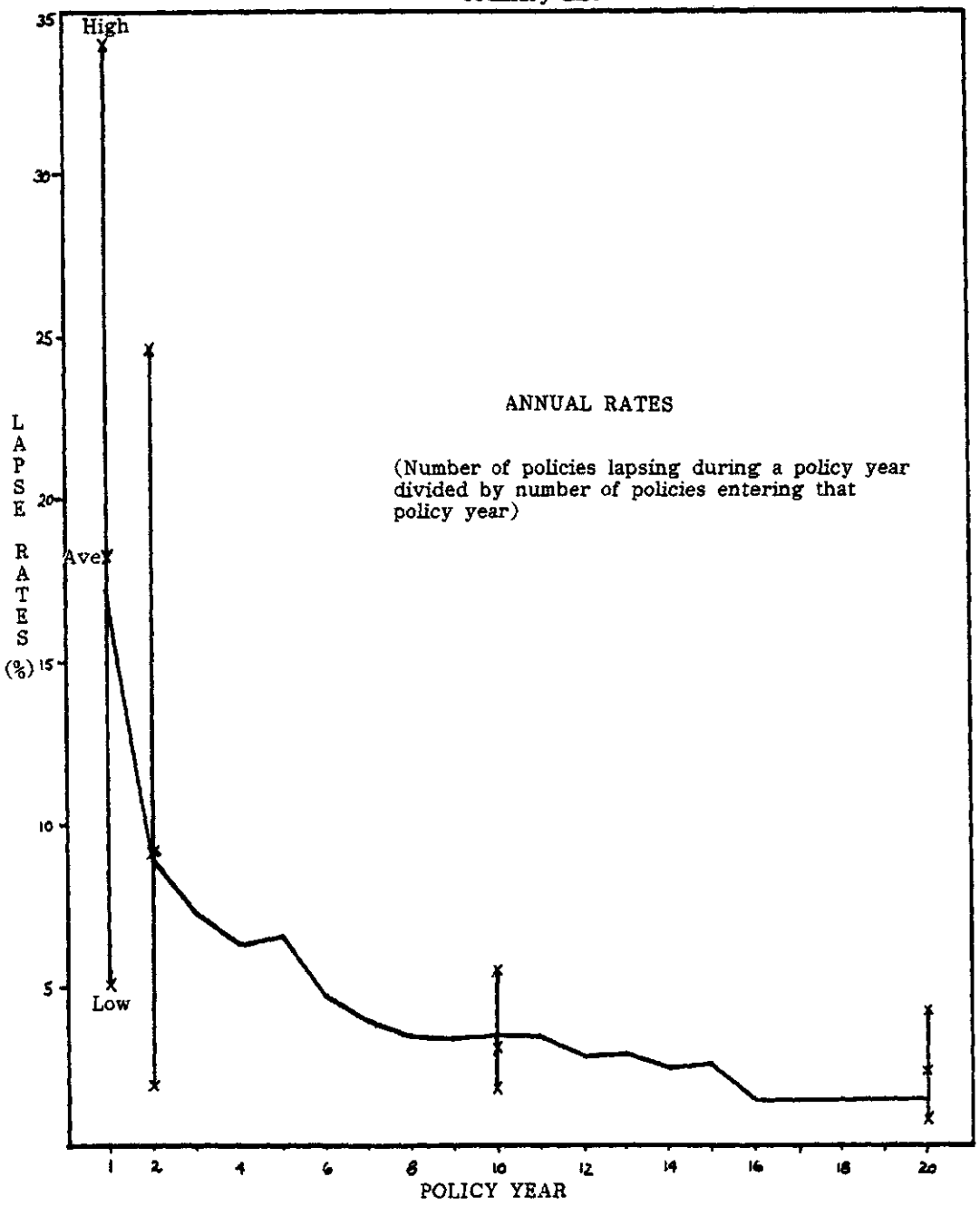
(1) Hart hearings, Part 4, page 2887-2891, reproduced in EXHIBIT 1 of this report.

(2) Long-Term Lapse Study, A Financial Management Study, LIMRA, 1974, Table B, Age at Issue 35-39, page 32 and Table 21, page 26.

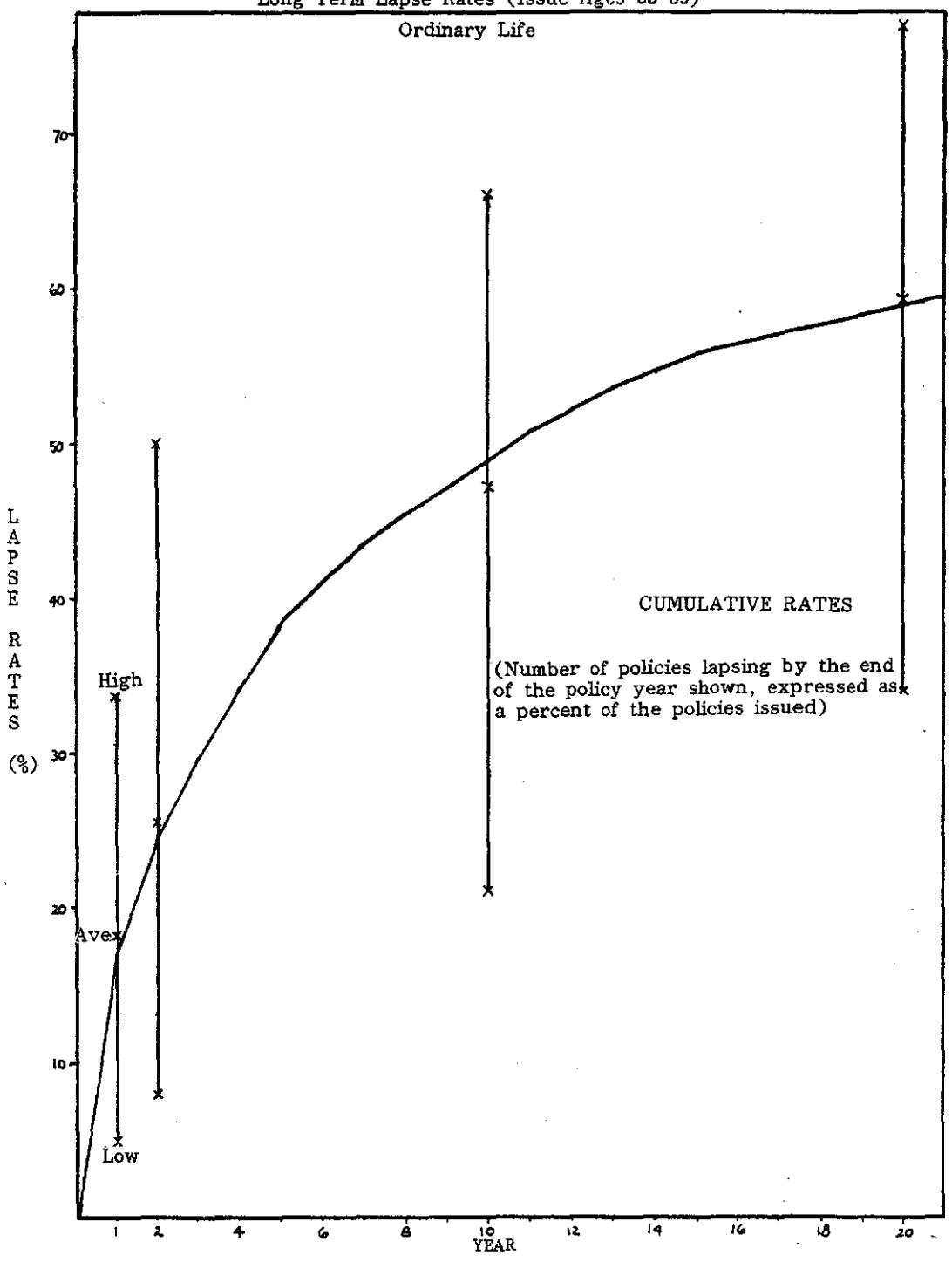
(3) Differences in the average rates result from different sets of companies used and from a difference in the content of data from each source.

GRAPH 3

Long-Term Lapse Rates (Issue Ages 35-39)
Ordinary Life



GRAPH 4
Long-Term Lapse Rates (Issue Ages 35-39)



Situation 2

Two large mutual companies reported very different results to the Hart Committee. One showed only a 45 percent cumulative lapse rate at the end of 30 years as compared to 58 percent for the other company. Before passing judgment on the second company, an analysis of each company's business is made. In this case, it was found that the company with the lower lapse record sells only premium notice business with a heavy emphasis on business insurance and estate planning (i.e., business with inherently good lapse experience). On the other hand, the second company was found to be a combination company with primarily debit operations (i.e., selling in markets with inherently poor persistency experience). Thus, even though we witness a difference in persistency between these two companies, the difference is an expected one due to their different markets of operation.

Chapter III (What Are Factors Affecting Persistency?) and Chapter VII (A Disclosure System) provide further insight into the analysis of lapse rates.

In summary, even though early lapse rates have been fairly stable over the years, there is concern about the companies whose lapse rates are significantly above the industry average. The committee cautions, however, not to prejudge a company until some analysis is made concerning its markets of operation and mix of business.

CHAPTER III

WHAT ARE FACTORS AFFECTING PERSISTENCY?

A. Introduction

The basic question of what is causing lapses, currently being asked by the regulators, has been under study for many decades by the insurance industry. This chapter addresses the question in its broadest sense -- i.e., "what are factors affecting persistency?"

A literature search on persistency discloses the fact that an exhaustive amount of research has been done over the years on the factors affecting persistency. By the early 1930's LIMRA had already identified a number of factors related to the prospect and the sale as being predictive of persistency. In order to further explore the interrelationships among the factors which might be valid predictors of persistency, LIMRA's Buyer Studies (which profile the characteristics of the buyers and the products being sold) were used as the base for subsequent persistency studies.

The first such persistency study was made with a five-year exposure period for a group of policies issued in 1942(1). Subsequent analyses have indicated that the relationships between various factors and persistency determined on a five-year basis and a two-year basis are very similar (primarily because a large proportion of the terminations occur in the first two years). Thus, later studies were made mostly on a two-year basis. Such studies have been made on policies issued in 1949(2), in 1960(3), and in 1966(4). A similar 25-month LIMRA persistency study of 1974 issues is currently under way, with publication scheduled for early 1979.

LIMRA's studies of persistency beyond the early policy years began with a nine-year follow-up study of 12,111 policies issued in May 1949 by 54 companies(5). This study added considerably to the knowledge of factors affecting lapses occurring in a block of business over a span of years. LIMRA's most recent investigations into the nature of long-term persistency are based on the experience of a group of companies whose standard ordinary policies (new business and inforce) are followed from one policy anniversary to the next(6). Again, these long-term lapse studies have not only reaffirmed what was gleaned from the early policy year studies but also have added additional dimensions to our studies of factors affecting persistency.

These LIMRA persistency studies, along with persistency studies conducted by individual companies, were used as the basis for the following commentaries. The major observation drawn from this literature search is that the results are generally consistent over the years -- particularly so far as relations between various factors and persistency are concerned. It is this consistency of the findings over the years that precludes persistency studies from being conducted on a more frequent basis.

(1) LIMRA, Persistency 1942-1947, A Quest for Predictive Factors, Research Report 1949-1 (File 720).
(2) LIMRA, Persistency 1949-1951, The Two-Year Persistency of Ordinary Life Insurance, Research Report 1953-6 (File 720).
(3) LIMRA, Persistency 1960-1962, Sales by Ordinary Agents to Male Adults, Research Report 1964-6 (file 720).
LIMRA, Persistency 1960-1962, Ordinary Sales by Combination Agents to Male Adults, Research Report 1965-4 (File 720).
(4) LIMRA, Persistency 1966-1968, Sales by Ordinary Agents to Male Adults, Research Report 1972-5 (File 720) and LIMRA, Persistency 1966-1968, Sales by Combination Agents to Male Adults, Research Report 1972-9 (File 720).
(5) LIMRA, Persistency 1949-1958, Research Report 1960-3 (File 720).
(6) LIMRA, Long-Term Lapse Study, 1972-1973 Experience, A Special Research Report (File 720).

The preliminary results from LIMRA's persistency study currently under way (a 25-month persistency follow-up of 1974 issues) are used in some of the discussions that follow. These preliminary results again show the same relationships as previous studies between various factors and persistency. However, the levels of persistency from the current study are lower and may be related to the long economic recession of this two-year study period (1974-1975) during which time unemployment reached peak levels.

LIMRA's two-year and long-term persistency studies are quoted generously throughout this chapter. In view of this, a generalized definition of lapsation as used in each of these studies follows:

25-Month Persistency Data

Policies are defined as in force if 25 months' premium were paid, including payment by loan or premium waiver. When term policies are converted, there is no lapse and the inforce classification is based on a continuation of the policies prior to conversion. A similar method is employed for preliminary term policies; the exposure period includes the preliminary term period. Renewable term policies that do not renew are considered as lapsed. Those policies classified as not in force include those lapsed without value, those surrendered for value, those on extended term, and those on reduced paid-up status.

Long-Term Lapse Study Data

The same lapse definitions (as stated above) apply, with the following additions:

(1) Expiries, maturities, or nonrenewal of renewable term insurance (except for one-year renewable term) are not defined as lapses.
(2) If possible, companies were requested not to consider as a lapse the termination of term insurance due to conversion to permanent insurance.

B. Overall Lapse Rate Interpretation

It is difficult to interpret and evaluate an overall lapse rate without additional information pertaining to the characteristics of the marketplace of operation. This is a critical point to be kept in mind whenever lapse/persistency rates are studied.

To illustrate this point, a comparison of the lapse rates for ordinary agents and combination agents(1) is reviewed here.

(1) Combination agents are those agents who sell ordinary policies on both the debit collection basis and the premium notice basis. Ordinary agents sell ordinary policies only on the premium notice system.

While it has long been recognized that on an overall basis the persistency of policies sold by ordinary agents is higher than for their combination colleagues, studies have consistently shown that most of this difference disappears when recognition is given to differences in mode of premium payment and income of insured. This is shown in TABLE 3.

TABLE 3

Policies Sold in 1974 to Male Adults by Full-Time Agents

	25-Month Persistency		Distribution of Paid-for Policies	
	Ordinary Agents	Combination Agents	Ordinary Agents	Combination Agents
By Premium Mode				
Annual	81%	76%	22%	6%
Semiannual	73	75	8	2
Monthly bank plan	72	65	30	10
Salary savings	73	73	6	1
Quarterly	62	71	12	7
Regular monthly	61	59	22	20
Monthly debit ordinary	NA	52	NA	52
Weekly premium ordinary	NA	57	NA	2
All premium modes	70	58	100	100
By Income of Insured				
$25,000 and over	80%	*	7%	1%
$15,000 - $24,999	77	72%	17	7
$10,000 - $14,999	70	63	36	24
$ 7,500 - $ 9,999	63	55	17	22
Under $7,500	60	44	12	31
Unemployed, students, and retired people	74	77	11	15
All income classes	70	58	100	100

*too few cases to analyze
NA = Not Applicable

Most of the 12 percentage point average difference between the ordinary and combination agents is generated by the difference in the mix of business rather than by the quality of business sold by each type of agent. For example, the distribution of paid-for business (which serves as the production base on which the rates in

TABLE 3 are based) indicates that 54 percent of the combination agents' production is debit ordinary business, which has inherently lower persistency rates. If this block of business is removed from the combination agents' data, the average persistency of the remaining premium notice business becomes 65 percent -- a seven percentage point difference from the initial overall rate of 58 percent. The comparison of premium notice persistency rates thus becomes 70 percent for the ordinary agent and 65 percent for the combination agent.

The next step in the comparison of these two rates is to make the mix of business consistent regarding the proportion of business sold under each mode of premium payment. To do this, let's assume that the combination agents sell only premium notice business and that the modal distribution of this business is identical to that of the ordinary agents. With these assumptions, the overall premium notice persistency rate for the combination agents becomes 68 percent, which may then be compared to the 70 percent overall rate for the ordinary agents.

A similar exercise may be applied to the "income of insured" categories in the bottom half of TABLE 3. There, for example, it can be noted that 60 percent of the ordinary agents' sales are in the $10,000 and over income categories as compared to only 32 percent in these income categories for the combination agents' markets. By noting, also, the more favorable persistency in higher "income of insured" categories, one realizes the affect distribution of such sales characteristics has on the overall persistency.

C. Factors Affecting Persistency

Persistency studies have consistently shown that income of the insured and mode of premium payment are the major factors related to persistency -- i.e., as TABLE 3 illustrates, persistency improves as income increases and improves with less frequent premium payments. Higher income implies a greater ability to meet premium payments and greater reserves to meet unexpected expenditures. It also may reflect greater life insurance needs and more programming and more complete services from the agent. Furthermore, interview studies suggest that a financial variable or set of variables may be implicated which are not being entirely accounted for by current income. They suggest that among buyers with equal incomes, those who will lapse are ones with weaker financial positions -- i.e., those less likely to have checking accounts, who have lesser amounts of savings, who have more debt, etc. It is a variable that might account for the choice of the more frequent modes of premium payment and the vulnerability of policies to income reduction or unanticipated expenditures.

It becomes obvious from persistency studies that the principal factors affecting persistency have interrelationships with one another; and yet each is related to persistency independently of the others. This independence and interdependence are particularly apparent in the factors of mode of premium payment and income of insured.

TABLE 4 indicates the interdependence of mode and income -- e.g., the proportion of policies paid for on an annual basis increases as income increases. Conversely, the proportion of policies paid on a regular monthly basis increases as income decreases.

The persistency rates in TABLE 4 illustrate that mode and income are, nevertheless, independently related to persistency -- i.e., differences in persistency rates according to mode may be found within each income group.

Similar results are found for combination agents.

TABLE 4

Policies Sold in 1974 to Male Adults by Full-Time Ordinary Agents

Premium Mode	Income of Insured: Under $7,500	$7,500-$9,999	$10,000-$14,999	$15,000-$24,999	$25,000 and over	All Policies
	Distribution of Policies By Mode and Income					
Annual	13%	12%	18%	28%	43%	22%
Semiannual	8	8	7	9	7	8
Monthly bank plan	25	34	35	30	24	30
Salary savings	9	8	5	5	3	6
Quarterly	14	11	12	11	11	12
Regular monthly	31	27	23	17	12	22
	100%	100%	100%	100%	100%	100%
	25-Month Persistency for Each Cell					
Annual	77%	81%	81%	82%	87%	81%
Semiannual	65	74	69	72	84	73
Monthly bank plan	64	65	72	79	80	72
Salary savings	51	65	77	87	*	73
Quarterly	58	55	62	68	61	62
Regular monthly	55	51	63	71	72	61
All premium modes	60	63	70	77	80	70

*too few cases to analyze

Other factors which have some relationship to persistency, when "corrected" for their relationship to premium mode and income of the insured, can be categorized as follows:

1. buyer related factors,
2. product related factors,
3. agent related factors,
4. post-sale related factors, and
5. factors related to the outside environment.

Each of these five categories is analyzed in the following pages.

1. Buyer Related Factors

Age of Insured

Persistency studies reveal young adults, ages 20-29, to be most likely to lapse. This age effect appears to be associated both with age at issue and when the insured is passing through the 20-29 attained ages. These higher lapse rates for issue ages 20-29 may be observed in the following tabular information developed from the intercompany data bases in LIMRA's Long-Term Lapse Study.

TABLE 5

Long-Term Lapse Study
1975 - 1976 Experience

Policy Years	Age at Issue 0-19	20-29	30-39	40-49	Over 49	All Ages
1	14.6%	18.6%	14.6%	11.4%	9.2%	15.2%
2	7.3	11.1	9.9	7.9	6.6	9.4
3 - 5	4.0	7.0	6.8	6.3	6.0	6.2
6 - 10	2.8	4.5	4.4	4.3	4.9	4.2
11 - 15	2.4	2.8	2.8	3.1	4.0	2.8

As the table indicates, the persistency of business improves as the age of the buyer increases and as the young adult buyer matures. Age may be a proxy for more basic factors, such as: increased maturity or sophistication as a buyer; the presence of an established agent-client relationship; perhaps more clearly defined needs; more responsibility; etc. The high lapsation occurring among the young adults may be the result of initial or increased financial obligations often assumed at these ages, accompanied by the lack of experience in financial matters.

Occupation of Insured

Persistency enjoys a higher mark with the professional and executive group of policyowners. Likewise, students show higher persistency, and this may result from the fact that premiums are paid by someone other than the insured. On the other hand, the better than average student lapse rate may be the result of financed insurance, which may be subject to higher lapsation in subsequent years.

TABLE 6

25-Month Persistency --
Policies Sold in 1974 to Male Adults by Full-Time Ordinary Agents

Occupation of Insured	Percent in Force
Professionals, executives	76%
Salesmen	68
Craftsmen, foremen	67
Clerical, sales workers	67
Operatives, service, labor	63
Military personnel	67
Students, age 15 and over	74
All Occupations	70

Previous Ownership of Life Insurance

Policies sold to males who are already policyowners in the same company are more persistent than those sold to other males.

TABLE 7

25-Month Persistency --
Policies Sold in 1974 to Male Adults by Full-Time Ordinary Agents

Previous Ownership	Percent in Force
Yes	80%
No	67
All Buyers	70

Purchase of an additional policy from the same company would appear to be a vote of confidence for the agent, the company, and/or the service obtained after the first purchase.

Students and/or Juveniles

Juvenile policies (issue or attained ages of 14 or under) show consistently higher than average persistency rates at each

policy duration. LIMRA's persistency studies, however, do not contain information on the premium payor; nor do the studies have information pertaining to the interaction of mode of premium payment on the overall persistency rates of juvenile policies. Perhaps the persistency study currently under way will elicit some insight into the better experience of juvenile policies.

As indicated in TABLE 6, the student population age 15 and over has better than average persistency. The independence of this factor in its effect on persistency cannot be studied until information concerning the premium payor becomes available or until information concerning the financing of this business is obtained and its long-term persistency studied.

Sex of Insured

The two-year persistency rate for policies sold to female adults has traditionally been higher than the corresponding rate for sales to male adults. For example, the two-year persistency study based on 1966 ordinary sales indicates a rate of 75 percent for female adults versus a rate of 72 percent for male adults.

Previous two-year persistency studies indicated that if an attempt is made to correct for the differences in income between the gainfully employed females and gainfully employed males, the difference in persistency rates becomes much more significant.

LIMRA's long-term lapse studies also indicate that males have a slightly higher lapse rate (by number of policies). These studies indicate that the female superiority in persistency by number is noticeable among all adult age groups and for all policy durations.

2. Product Related Factors

Type of Policy

LIMRA's two-year and long-term persistency studies indicate that permanent insurance enjoys superior persistency to that of term insurance. See TABLE 8. The percentage difference in persistency evidenced in the first policy year increases with the duration of the business; i.e., the renewal lapse rates of term business decline at a slower pace than permanent rates after the first year and eventually settle at about 80 percent higher than the permanent rates.

This superiority of permanent insurance policies doesn't hold true for all kinds of term policies. LIMRA's two-year persistency studies indicate that decreasing term policies, especially of the mortgage variety, exhibit better persistency than that displayed by all policies, term and permanent, combined.

TABLE 8

Long-Term Lapse Study
1975 - 1976 Experience

Lapse Rates By Number of Policies

Policy Year	Permanent	Term
1	15.1%	16.2%
2	8.6	13.4
3 - 5	5.8	9.6
6 - 10	4.0	6.3
11 - 15	2.7	5.2
16+	2.6	4.7

Amount of Annual Premium

Persistency, in general, increases with the size of the annual premium.

TABLE 9

25-Month Persistency -- Policies Sold in 1974 to Male Adults

	Percent in Force	
Amount of Annual Premium	Ordinary Full-Time Agent Sales	Combination Full-Time Agent Sales
$750 & Over	81%	64%
$400 - $749	75	
$200 - $399	70	58
$199 & Under	68	58
All Policies	70	58

These relationships cannot be attributed to variation in income and mode of premium payment. However, a considerable portion of the trend by premium amount may be due to the relationship with age. As previously stated, policies sold to older males have higher persistency -- and these policies have higher premium rates per $1,000 of insurance and, hence, higher amounts of annual premium.

Type of Underwriting

In the early policy years, medically underwritten policies have the best persistency, followed by paramedical and then nonmedical. Beyond these early years, however, medical policies have only slightly lower lapse rates than nonmedical policies.

TABLE 10

Long-Term Lapse Study
1972 - 1973 Experience

Lapse Rates By Number of Policies

Policy Year	Medical	Paramedical	Nonmedical
1	12.6%	17.4%	21.6%
2	6.5	7.4	9.0
3 - 5	4.8	--	4.8
6 - 10	3.0	--	3.2
11 - 15	2.2	--	2.3

Data limitations have not made it possible to study the effect of income and mode of premium payment on the observed differences in experience in the early policy years. It is likely, however, that such forces are at play since the average size medically underwritten policy in the long-term lapse studies was more than three times that of the average nonmedical policy.

Preferred Risk and Minimum Amount

A small percent of policies sold by ordinary agents to male adults in the 1960-1962 persistency study(1) was issued on a preferred risk basis with high minimum amounts of insurance. These preferred risk policies (with high minimum amounts) had significantly better persistency than other policies (84 percent versus 77 percent).

Issued as Applied For

The 1949-1951 persistency study(2) of combination agent sales to male adults found that in the middle and upper income

(1) LIMRA, Persistency 1960-1962, Sales by Ordinary Agents to Male Adults, Research Report 1964-6 (File 720).
LIMRA, Persistency 1960-1962, Ordinary Sales by Combination Agents to Male Adults, Research Report 1965-4 (File 720).

(2) LIMRA, Persistency 1949-1951, The Two-Year Persistency of Ordinary Life Insurance, Research Report 1953-6 (File 720).

groups, persistency is considerably better for policies which are issued as applied for than for those issued other than as applied for. A comparable study of ordinary agent sales to male adults found no such relationship.

Waiver of Premium

The 1949-1951 persistency study(1) also found that in the combination agent male adult market, policies containing a waiver of premium provision showed higher persistency in each income group than those without such a provision. On the other hand, this factor showed no relationship to persistency among buyers from ordinary agents.

Pension Business

Long-term lapse studies have found that pension trust lapse rates remain near the first-year level throughout the first five years and then decline only gradually. Nonpension lapse rates, on the other hand, drop sharply from the first year to the second year and then assume a more gradual decline.

This pattern of lapsation for the individual pension trust policies may be due to several reasons: unemployment rates in the economy, job mobility, and the termination of a pension plan which has a large number of policies in the plan. It is said that, on the average, the employed person changes employment every five years, and such termination of employment will often bring about the lapse or surrender of one or more pension trust policies.

High Early Cash Value Plans

Individual company and aggregated studies of long-term lapsation indicate that high early cash value policy lapse rates are only about half those of other policies in the first policy year. However, in the third and subsequent policy years, high early cash value lapse rates are considerably higher than other policies, for it is in these years that the cost of these "minimum deposit" policies begins to catch up with the policyowner.

(1) Ibid.

TABLE 11

Long-Term Lapse Study
1972 - 1973 Experience

Lapse Rates By Number of Policies

Policy Year	High Early Cash Value Plans	Other Plans
1	9.4%	19.1%
2	6.6	8.5
3 - 5	9.3	5.0
6 - 10	5.2	3.3
11 - 15	3.5	2.4

3. Agent Related Factors

Agent's Length of Service and Survival

Early lapse rates for policies sold by new ordinary agents who are destined for early failure are significantly higher than those sold by new agents who will survive. Among survivors, the ability to write persistent business grows as length of service increases.

TABLE 12
25-Month Persistency --
Policies Sold in 1974 to Male Adults by Full-Time Ordinary Agents

Classification of Agent	Percent in Force	
Experienced Agents (more than 3 years)	77%	
New Agents (3 years or less)	62	
Agent survived exposure period		68%
Agent terminated in exposure period		50
All Agents	70	

The studies show that some of the difference in these persistency rates is due to the fact that experienced agents operate in markets which possess better persistency than new agents who survive the exposure period; and the new agent survivors operate in better persistency markets than the new agent terminators. (Markets which possess better persistency are defined as markets with higher incomes, older applicants, better occupations, larger premiums, etc.) However, this is

only part of the difference. Within each separate category of market characteristics, the policies sold by experienced agents show better persistency than those by new agent survivors, who in turn show better persistency than new agent terminators.

The difference in persistency of policies sold by new agent survivors and new agent terminators is just as great for combination agents as for ordinary agents.

TABLE 13

25-Month Persistency --
Policies Sold in 1974 to Male Adults by Full-Time Combination Agents

Classification of Agent	Percent in Force	
Experienced Agents (more than 3 years)	65%	
New Agents (3 Years or less)	50	
Agent survived exposure period		59%
Agent terminated in exposure period		39
All Agents	58	

In contrast with sales made by the experienced ordinary agents, deeper analysis showed there is no concentration of sales made by experienced combination agents in those areas associated with high persistency. Instead, the distribution of policies shows that the market concentration for all full-time combination agents is among those paying on the monthly mode, policies with lower premiums and buyers with lower incomes, at younger ages, etc. -- none of which exhibit superior persistency. However, experienced agents generally show higher persistency than do new agents in each of the analyzed market segments.

Insurance Knowledge

Persistency is positively related to the level of the agent's product knowledge -- i.e., the better an agent's knowledge of his product, the more likely it is that the agent will write persistent business. LIMRA's 1957 study(1) indicated that the results of the study were not due to other factors such as the agent's age, formal education, or months of experience with the company.

(1) LIMRA, Insurance Kowledge and Performance, Research Report 1957-4 (File 450).

Education of Agent

An earlier persistency study done by one company in collaboration with LIMRA found that among agents who survived the exposure periods, formal education does not have any relationship to the predicted persistency of business.

Orphan Policyowners

In a study(1) of the persistency of policies sold by terminating agents, LIMRA found that the poor persistency of orphan business is attributable to the fact that agents who leave the business are poor quality agents and, therefore, sold poor quality business. The data showed that improvement in persistency is more likely to result from efforts to improve the agency force and the conditions surrounding the sale than from efforts to keep on the books poor quality business, poorly sold.

4. Post-Sale Related Factors

Policy Loans

In the early fifties, one company investigated the effect of policy loans on policy termination. Its data showed that policies with loans have a consistently higher surrender rate than those not having loans. Yet, another company made a policy loan study with a distinction between cash loans and automatic premium loans. Its report indicated that the number of policies lapsing with automatic premium loans is three to four times the number lapsing with cash loans.

Reasons for Policy Terminations

A significant proportion of lapsed or surrendered policies are terminated because of surprise events that affect ability to pay, reduce need, or introduce the replacement factor. The following results of a company study conducted in the sixties is consistent with the results of other lapsed policyowner studies.

Other individual company studies of lapsed and surrendered policies also indicated a striking 25 percent of terminating policyowners who replaced their policies with new life insurance.

---

(1) LIMRA, Factors Affecting the Persistency of "Orphan Business", A Study of the Five-Year Persistency of 4,061 Adult Policies Sold by Ordinary Agents, Research Report 1948-6 (File 710).

TABLE 14

Distribution of Reasons for Termination: 1960-1961

		All Lapses				1st and 2nd Year Lapses (By Number)	
		By Number of Policies		By Amount of Insurance			
A.	"Client" Reasons						
	1. Family change altered need	8.0%		6.9%		2.7%	
	2. Business interest dropped due to business change	4.0		9.0		7.2	
	3. Illness or other emergency expenses	3.5		2.5		3.6	
	4. Moved out of town	5.9		4.9		5.5	
	5. Change or loss of job	7.7		6.8		8.9	
			29.1%		30.1%		27.9%
B.	"Solution" Reasons						
	6. Simply oversold	2.4%		2.8%		5.3%	
	7. Sale incomplete -- had "option" to buy	0.8		1.3		2.1	
	8. Not able to budget for premiums	17.2		17.5		26.7	
	9. Did not understand policy	1.8		1.9		2.0	
	10. Wanted money for car, etc.	5.7		4.0		9.2	
	11. Technical change in policy title	0.1		0.1		0.2	
			28.0%		27.6%		45.5%
C.	"Dissatisfaction" Reasons						
	12. Dissatisfaction with agent or agency	0.9%		1.4%		0.9%	
	13. Dissatisfaction with company handling or rating	2.2		3.4		3.3	
	14. Wife's opposition a factor	1.6		1.4		3.3	
	15. Personality problems	1.0		1.2		1.4	
			5.7%		7.4%		8.9%
D.	"Replacement" Reasons						
	16. Relative or agent who left	2.4%		2.1%		4.6%	
	17. Policy replaced	17.0		17.5		13.1	
	18. Money for mutual funds or stocks	4.6		4.2		--	
			24.0%		23.8%		17.7%
E.	"Other Surrender" Reasons						
	19. Money for business	5.5%		5.3%			
	20. Money for house, real estate	3.7		3.3			
	21. Money for education	1.3		1.0			
	22. Money for retirement	2.7		1.5			
			13.2%		11.1%		
			100.0%		100.0%		100.0%

5. Factors Related to the Outside Environment

The Economy

Much research yet needs to be done relating persistency to the variations in the economic climate. Past studies have indicated that persistency tends to be poorer during periods of unemployment and high interest rates. On the other hand, persistency tends to improve when personal savings and effective buying incomes are high.

Economic variations have greater influence on business older than two years than on the new business. The hypothesis is that the newer business has been purchased largely by those who are not significantly affected by a prolonged recession. Very few marginal purchasers can take on a policy in those periods.

The Competition

Growing competition offered by competitive investment media increases surrenders of policies. One company that studied surrenders between March and July of 1967 found that 17 percent of the lapsed policyowners dropped their policies because of preference for other savings media. This figure would undoubtedly be higher today in view of the high competitive interest rates of today's economy.

D. Factors Not Affecting Persistency

Character of Agency

One study(1) of persistency classified agencies according to urban/rural characteristics of agency location. This study found a high degree of relationship with persistency, ranging from 70 percent for the purely rural regions to 80 percent for the largest metropolitan districts. However, further study indicated that most of this relationship was based on the correlation of income rather than the urban/rural characteristics of the agencies.

Size of Policy

The belief existed that the larger the policy, the more likely it was to persist. Yet, past research indicates there is no difference in the persistency by size of policies within income groups. Naturally, there is a relationship between income and size of policy; and, since policyowners with higher incomes tend to persist

(1) LIMRA, Persistency 1949-1951, The Two-Year Persistency of Ordinary Life Insurance, Research Report 1953-6 (File 720).

better than those with lower incomes, a study which combines policies from all income levels shows a spurious relationship between persistency and size of policy.

Other Variables

Other factors showing the same absence of intrinsic importance to the persistency problem were found to be:

1. marital status of insured (with the exception that married men are more persistent for the monthly modes);
2. type of agent -- full-time, part-time, broker; and
3. the settlement option or form in which proceeds were taken when termination occurred.

E. Replacements and the Lapse Problem

This report would be incomplete without some reference to replacements as a contributory cause of the lapsation problem. We will attempt to put this segment of the problem in perspective but not make recommendations, since there is a separate task force of the Life Insurance (C3) Subcommittee charged with the responsibility of coping with this specific situation(1).

Life policy replacements are becoming a major challenge for the life insurance industry. There is evidence that replacing business is in some cases an organized and deliberate sales strategy for some companies, as well as some individual agencies and agents. These operations are sophisticated in their methods and persuasive in some of their arguments for replacement.

In the late sixties, the NAIC began work on the current replacement regulation, which appeared in substantially final form in 1970(2). As this regulation was adopted, most marketing officers seem to have relied on it to:

1. provide a basis for establishing "good" versus "bad" replacement,
2. frustrate organized replacement activity through the barrier of detailed disclosure and comparison documentation,
3. place the burden of proof of value on the replacing company, and
4. impose a legal obligation on the replacing agent to fairly represent the merits of the replacement.

---

(1) For a reasonably concise description of that task force's activities and a wide sampling of comments, please refer to the series (New Policies for Old) by Janis M. Pasculli, The National Underwriter, Life and Health Edition, May 6, 1978 through May 20, 1978.

(2) NAIC Proceedings, 1970 Volume I, pages 345-350.

In recent years, three events have occurred that seriously undermine the thrust of this regulation:

1. The relatively high rate of inflation in recent years has caused some classically "bad" replacements to become "good" replacements. The substance of some replacement sales presentations shows what a "bad" buy some moderate vintage insurance plans are for the continuing policyowner relative to some current buys in the market.

2. Loss of consumer confidence in the long-term value of money materially affects a policyowner's willingness to accept a replacement argument. Permanent plans and deferred annuities, often originally sold for their values at retirement, are especially susceptible to "new money" and "invest the difference" replacements. This cuts at least two ways: the policyowner is indifferent toward the proof and merits of the replacement, having noticed only some high interest rate; and there is a loss of policyowner confidence in the original agent and company.

3. Access to computer processing has significantly increased in recent years. The proliferation of commercial outfits offering computerized support services to agents and companies is clear evidence of its impact in the insurance industry. A natural "service" is providing policy comparison and disclosure documents. Some of these commercial outfits specifically advertise a complete replacement document service.

Industry studies on the extent of replacement practices and their impact on the lapse problem are virtually nonexistent, due to the fact that:

(a) not all states have adopted the replacement regulation which would provide the basic data for such a study;
(b) there is no easy way to monitor whether intercompany replacements are being reported as such in the states which have adopted the replacement regulation; and
(c) it is difficult to define a replacement, particularly if the policy is lapsed or surrendered at a time other than when the new policy is purchased.

An effort in capturing some information as to the extent of the replacement problem was recently made at the University of Wisconsin(1). The study, based on a limited number of policies,

(1) Scheel and Van Derhei, variously published as "Replacement Sharks in a Goldfish Bowl" Best's Review, Life and Health Edition, June and July, 1977 and "Replacement of Life Insurance: Its Regulation and Current Activity" Journal of Risk and Insurance, XXLV No. 2, June, 1978, pages 189-216.

reported that approximately 3 percent of surrendered policies (policies with cash values) and 1 percent of lapsed policies (policies without cash values) involved replacement. Even though the effect of replacement on lapsation may be relatively minor on an "industry" scale, the impact for an individual company may be very significant.

The same University of Wisconsin study reported that both the replacement of other companies' policies and the loss of policies to other companies via replacement are subject to wide variation. One company was reported to generate as much as 42 percent of its new business from replacements, while others were reported to have attributed as much as 25 percent of their surrendered policies to replacement activities of other companies. In the survey underlying this report, one smaller company reported that 73 percent of its lapsed policies were replaced with policies of other companies.

In April 1977, Nebraska Director of Insurance Balka, acting for the NAIC, organized a task force of industry representatives to formulate a new replacement regulation. We can only hope that the task force charged with that responsibility is successful in coping with this difficult issue.

Even though we cannot currently measure the impact of replacements on the lapse problem, we hope that this report on lapsation will contribute to a reduction in replacements, to the extent that it promotes business which is more appropriately sold and promotes the conservation of business after it is sold.

Persistency, as summarized in this chapter, depends on

- to whom the insurance is sold,
- what insurance is sold,
- who sells it, and
- what happens after the sale.

CHAPTER IV

WHAT IS EFFECT ON COST OF INSURANCE?

A. The Question

One of the six "global" questions specifically identified in our committee's charge is:

> "4. What effect do lapses have on rates for all other insureds?"

The word "rates" has been translated to mean "cost of insurance", and by "other insureds" we assume is meant the body of persisters. Thus, the question becomes:

> "4. What effect do lapses have on the cost of insurance for persisting policyowners?"

This chapter attempts to answer that question.

B. Some Preliminary Thoughts

In this chapter we focus on cost of insurance as determined by the effect of lapses on the size of dividends generated on participating business. We also offer some remarks regarding how lapse experience relates to the cost of insurance on nonparticipating business through the determination of the premium. And the question addressed here focuses on the persisters as opposed to those who lapse.

The matter of cost to those who lapse is usually thought of in terms of "what is the extent of injury to consumers when lapses occur?" Indeed, that is addressed in Chapter V.

However, one should not be misdirected by the question we are dealing with here in Chapter IV. It does focus on persisters, but not to the total exclusion of lapsers. After all, a lapser is a persister to the point of lapse. Thus, the total lapse experience of an insurer will affect the dividends received and premiums paid while one is a persister, however long that may be. Brief reflection makes this point obvious, but it is stated so the reader is not misdirected, by the way the question is posed, to exclude entirely those who lapse.

The effect of lapses on the cost of insurance can be traced through several of the other factors which enter into pricing, such as:

- expenses, where the provision for expense in a (typically) level premium policy is less than the early policy years' expenses. Those policies which lapse in an early policy year thus depart when they are in a negative financial position. This deficit position must be absorbed by those policies which remain.

- interest, where there is an investment in a new policy, due to the unlevel expense incidence cited above. This can be viewed as an investment of the company's (i.e. stockholders' or other policyholders') funds just as surely as would be an investment in a bond or other more traditional medium. To the extent the

policy lapses when the invested assets are negative, it wasn't a very useful investment. And, indeed, a relatively high interest earned by the company in early years, coupled with high early duration policy lapses, can have a deleterious effect on policy costs. That represents a higher foregone cost for having invested in the lapsed policy instead of some other type of asset that would at least return the dollars invested. And the foregone cost is a direct function of the interest rate assumed to be earned on the alternate investment media.

- mortality, where high lapse rates can reflect antiselection against the company (i.e. stockholders or other policyholders). Poor mortality risks won't lapse; they perceive a need to retain the coverage.

Less directly traceable to cost factors but real nonetheless, one can relate the effect of good lapse experience to the company's investment in its agency staff. Persisting business not only pays commissions, and perhaps other compensation, to an agent; it also provides a feeling of being part of a rewarding, positive endeavor. That can contribute to the agent staying in the business, thereby reducing training and other turnover costs and producing higher quality results for all persisters.

C. The Methodology

The purpose of this chapter is to answer the question more specifically with numerical examples. To do this, certain calculations are performed for participating business, using varying lapse assumptions. These are calculations a company might use to determine annual dividends it could afford to pay to the insured. Year-by-year dividends which result for each set of calculations are the output. These are analyzed to determine the variation thus caused in the cost of the insurance.

(Note: While this paper ignores the technicalities of the calculations, the reader may recognize that these dividend-determining calculations technically are referred to as "retrospective asset shares". They show the accumulated asset position of a particular policy according to certain assumptions. These results represent all policies similarly situated as to plan, issue age, sex, policy duration and amount of insurance.)

To make the calculations manageable, they are performed for two plans (Ordinary Life and Ten Year Term) and one issue age and

sex (male age 30). The results are illustrative and thought to be adequate to answer the basic question posed.

The plans were chosen with forethought and no particular bias. The Ordinary Life plan is perhaps the most common "permanent" plan, with premiums and death benefits level for life. It receives the most frequent attention by nearly all parties who analyze life insurance and particularly those who discuss lapse rates experienced by the industry. At the same time, such discussion sometimes seems to suggest that lapse rates on term plans are immaterial. They aren't, as regards cost of insurance, as this research shows. Thus the spectrum is more fully covered in a balanced fashion if term is also considered. Ten Year Term, convertible but not renewable, with level premiums and level death benefits for the full ten years, was the term plan chosen because of the relative ease in defining assumptions and performing resulting calculations.

Three sets of lapse rates are assumed for each plan. The "low" set of lapse rates are nonexistent; that is, there are no lapses. This seemed an appropriate base line to which results can be compared, given our basic question. The "medium" set are those from a published LIMRA table based on their long-term lapse study experience. The "high" set are double the "medium" set. Thus, symmetry between the three sets is achieved, facilitating comparison of results.

It should be noted that, in reality, lapse experience that varies as much as the three sets of assumptions used here would cause a company to consider different price structures and/or surplus objectives. A company might experience different expense patterns and could afford different commission rates. What and how those might change, or be changed, with widely differing lapse experience is purely speculative. For purposes of this study it is both necessary and sufficient to hold constant all factors except the lapse rates.

For all three sets of calculations on the Ordinary Life plan, all assumptions (other than lapses) remain fixed, as do surplus objectives and methods of calculation. The same is true of the three sets of Ten Year Term calculations. Thus, for either plan, any variation in resulting annual dividends-- the output -- is due solely to the change in lapses.

D. The Calculation Input and Assumptions

The price structure of the policies used in the calculations is intended to be fairly representative of the marketplace. For completeness, they are stated in EXHIBIT 2 at the end of this report.

Similarly, the assumed experience of the company is intended to be realistic under today's conditions. For completeness, all but the lapse rates are shown in EXHIBIT 3 at the end of this report.

It's important not to let one's attention be diverted to the details in either of these appended exhibits. While exhaustive studies of market pricing structures and company experience assumptions were not conducted, the data used are not unreasonable. Neither are they the point of this analysis. They are necessary raw materials, no more and no less. They are included in the report only for completeness and for the reader who might otherwise feel compelled to ask for them.

Of more direct interest, and worth some specific attention, are the specific lapse rates assumed.

Lapses for the Ordinary Life plan are equal to the LIMRA 1971-72 Permanent Expected Lapse Rates, 15 year select and ultimate. These "medium" rates are:

TABLE 15

Policy Year*	LIMRA 1971-72 Permanent Expected Lapse	Policy Year*	LIMRA 1971-72 Permanent Expected Lapse
1	14.54%	21	1.59%
2	6.21	22	1.59
3	5.03	23	1.59
4	4.40	24	1.58
5	4.11	25	1.55
6	3.49	26	1.54
7	3.20	27	1.61
8	2.89	28	1.74
9	2.59	29	1.86
10	2.30	30	1.94
11	2.14	31	1.95
12	1.97	32	1.98
13	1.86	33	2.18
14	1.79	34	2.69
15	1.75	35	4.00
16	1.59	36	3.60
17	1.59	37	2.60
18	1.59	38	2.09
19	1.59	39	1.91
20	1.59	40	1.93

*The lapse rate in policy year x is the percent of policies that paid the premium for policy year x but not for policy year x + 1.

For the Ten Year Term plan, we distinguish between two types of voluntary terminations -- those which are a lapse wherein all coverage ceases, and those which result from a contractual conversion to another type of plan. It is the former which are set at 0 percent, 100 percent and 200 percent of the expected lapses shown below. Conversion rates are held fixed at the percentages shown in EXHIBIT 3, on the assumption it's the termination resulting in cessation of insurance protection that we are most concerned about.

TABLE 16

Policy Year*	LIMRA 1971-72 Term Expected Lapse	Policy Year*	LIMRA 1971-72 Term Expected Lapse
1	16.73%	6	5.90%
2	11.79	7	5.23
3	8.62	8	4.57
4	8.17	9	4.02
5	7.84	10	3.61

* The lapse rate in policy year x is the percent of policies that paid the premium for policy year x but not for policy year x + 1.

As an interesting aside, one might ask what the implications of these lapse assumptions are as measured by the number of policies remaining in force at the end of selected policy years. This is displayed in EXHIBIT 4. Taken into account are the mortality and lapse rates and, for Ten Year Term, the assumed contractual conversion rate.

E. The Results

To measure the resulting dividends and thus cost of insurance, it was felt appropriate to use the measures prescribed by the NAIC Model Life Insurance Solicitation Regulation. These are:

Equivalent Level Annual Dividend = a level dividend assumed payable at the end of each year which, when accumulated at interest, will equal the actual dividends accumulated at the same rate of interest to the end of the period.

Net Payment Cost Index = the level annual premium, less the Equivalent Level Annual Dividend.

Surrender Cost Index = the level annual premium, less the Equivalent Level Annual Dividend, less a level amount assumed payable at the beginning of each year which, when accumulated at interest, will equal the guaranteed cash value (if any) at the end of the period.

The interest rate used in these index calculations is 5 percent, as prescribed by the NAIC model regulation.

A fourth measure, to show the longer duration effect, is also shown. This is the accumulated actual dividends to age 65 (Ordinary Life) or for ten years (Ten Year Term). The accumulation is made at 6 percent interest, a rate fairly typical of that actually being used by companies for such purposes.

The resulting annual dividends produce these "cost of insurance" measurements:

TABLE 17
(Per $1,000 of Insurance)

Measurement		Lapse Experience Low(=None)	Medium	High
	Ordinary Life			
*Equivalent Level Annual Dividend	10 Year	$ 2.88	$ 2.54	$ 2.01
	20 Year	5.48	5.26	4.86
*Net Payment Cost Index	10 Year	15.72	16.06	16.59
	20 Year	13.12	13.34	13.74
*Surrender Cost Index	10 Year	6.11	6.44	6.97
	20 Year	4.68	4.90	5.30
Dividends Accumulated at 6 percent	to age 65	887.18	866.24	829.82
	Ten Year Term			
*Equivalent Level Annual Dividend	10 Year	1.83	1.44	.18
*Net Payment Cost Index	10 Year	3.77	4.16	5.42
*Surrender Cost Index	10 Year	3.77	4.16	5.42
Dividends Accumulated at 6 percent	for 10 years	24.84	19.50	2.39

*Based on 5 percent interest and calculated as in the NAIC Model Life Insurance Solicitation Regulation.

(Note: The actual dividends are shown in EXHIBIT 5. On the Ordinary Life plan, the dividends are set somewhat artificially during the first 15 years in order to achieve the same financial position for the company (persisters) at the end of that time, regardless of lapse assumption. All initial deficits are repaid by that duration. Thereafter, dividends are paid annually as actually earned. For Ten Year Term, the plan achieves parity at the end of the tenth year for all three sets of lapse assumptions.)

Graphically, these annual dividends are depicted on the following two pages.

F. Some Observations and Analysis

1. As expected, the higher the lapse rates the more costly the insurance. This is shown on each of the measurements.

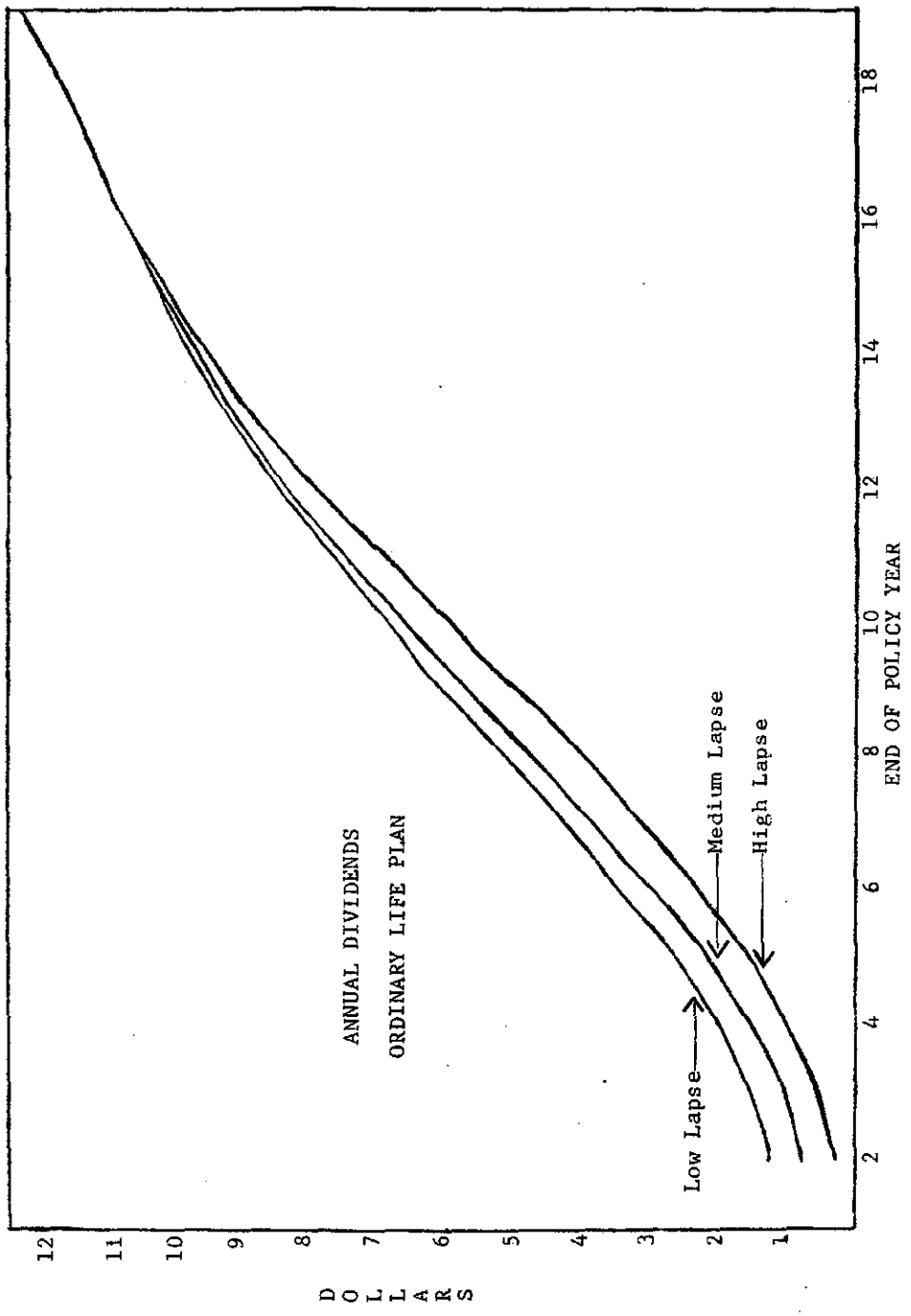
2. On all measurements, the difference in cost between the "medium" and "high" sets is quite a bit greater than the difference in cost between the "medium" and "low" sets. This is because the compounding effect of something like a 29.08 percent first year lapse rate on Ordinary Life ("high") is considerable when compared with 14.54 percent ("medium") or none ("low").

3. The Equivalent Level Annual Dividend may be the "purest" capsule number to look at for our purposes here. It encompasses only our variable output, the actual annual dividends produced. It levels them from the actual increasing scale (see the graphs) into what would be an equivalent level amount payable at the beginning of each year, from the beginning of the first policy year through the 10 or 20 year period. The leveling is done with the 5 percent interest assumption of the NAIC model regulation.

   (Note: this is not an equivalent scale from the perspective of our calculations which produce the actual dividends, for therein more than interest at 5 percent is considered.)

The change in the Equivalent Level Annual dividend is shown in the two sections of TABLE 18, the first when introducing lapses and the second when doubling them.

GRAPH 5


ANNUAL DIVIDENDS
ORDINARY LIFE PLAN
DOLLARS
1
2
3
4
5
6
7
8
9
10
11
12
Low Lapse
Medium Lapse
High Lapse
2
4
6
8
10
12
14
16
18
END OF POLICY YEAR

GRAPH 6

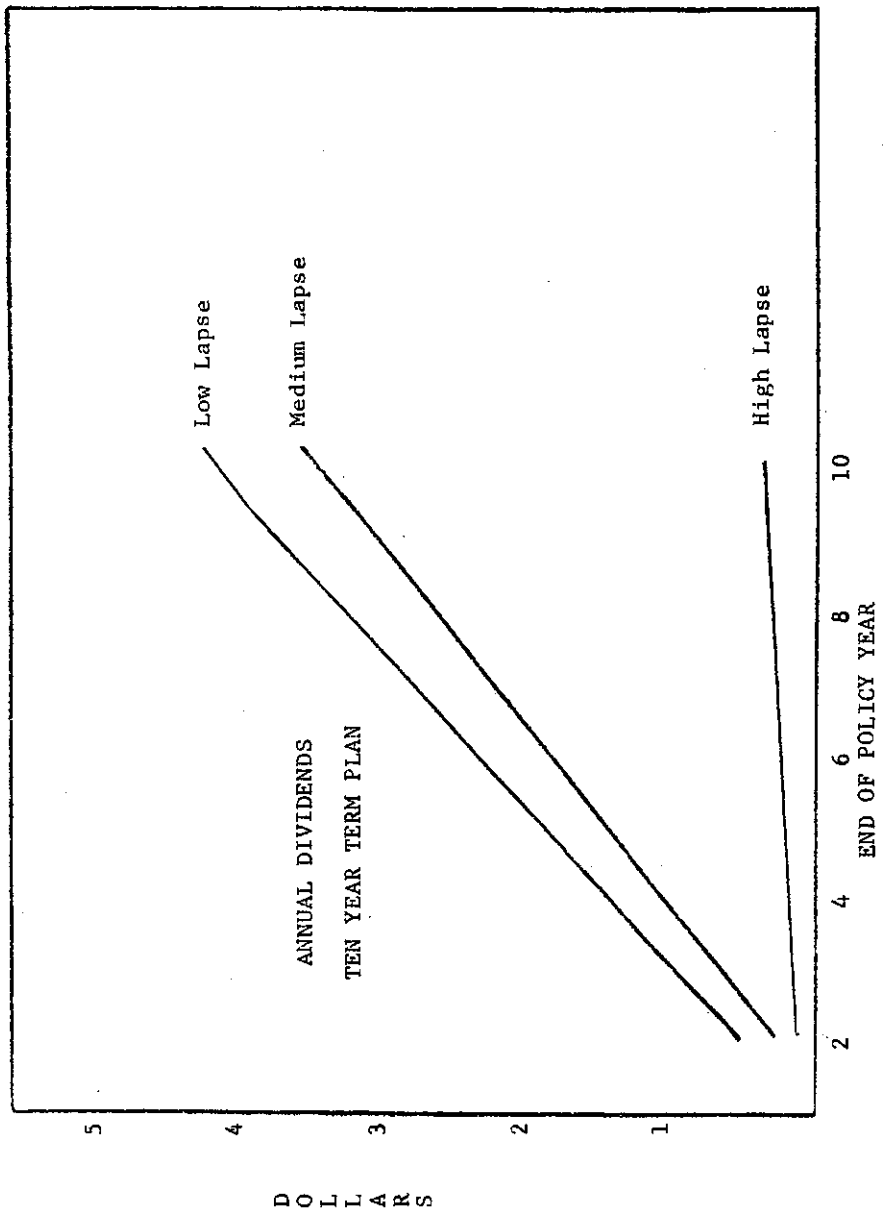

Low Lapse
Medium Lapse
High Lapse
ANNUAL DIVIDENDS
TEN YEAR TERM PLAN
DOLLARS
5
4
3
2
1
2
4
6
8
10
END OF POLICY YEAR

TABLE 18

	Equivalent Level Annual Dividend		
	Ordinary Life		Ten Year Term
	Over First 10 Years	Over First 20 Years	Over Full 10 Years
No Lapses	$2.88	$5.48	$1.83
LIMRA 1971-72 Lapses	2.54	5.26	1.44
Difference	.34	.22	.39
Percent Decrease*	-11.8%	-4.0%	-21.3%
LIMRA 1971-72 Lapses	2.54	5.26	1.44
Double LIMRA 1971-72 Lapses	2.01	4.86	.18
Difference	.53	.40	1.26
Percent Decrease*	-20.9%	7.6%	-87.5%

*It must be recognized that the percent reduction is partially a function of the general level of dividend one starts with initially.

G. A Partial Analysis of Early Funds

A different perspective on the effect of lapses on the company (persisters) can be gained by looking at the actual financial position of the sample policies in the very earliest years, according to our calculations.(1) How these funds (or "retrospective asset shares") track illustrates some of what we attempted to describe in Section B.

To simplify the analysis, we must define four "funds", each represented by a column in the subsequent two tables.

1. Assets Before Dividends = Column 1 = total accumulated assets for our sample policy assuming no dividends have been paid, assuming expenses, benefits and other factors as defined in EXHIBITS 2 and 3, and assuming appropriate charges for surplus the company must retain.

(1) We've assumed only annual premiums are paid, so we can look only at yearly increments. During the first year particularly, lapses on a modal premium basis -- say, in the extreme, after only one monthly premium has been paid -- would produce an even more negative financial situation for the company (persisters) than what we can depict with our examples.

2. Reserve = Column 2 = policy reserve on the defined basis, a liability the company must hold.

3. Accumulated Dividends = Column 3 = accumulated value of the dividends actually paid out, with the accumulation made with the assumptions used in the accumulations made in Column 1. (NOTE: the "retrospective asset share" is really the net of columns 1 and 3.)

4. Accumulated Deficit or Surplus = Column 4 = Column 1 - Column 2 - Column 3. This is the company's financial position on this policy after determining the assets attributable to it and deducting the liability held for it.

TABLE 19 shows these various funds for the Ordinary Life plan on each of the three sets of lapse assumptions. TABLE 20 does the same for the Ten Year Term.

TABLE 19

Ordinary Life

End of Policy Year	(1) Assets Before Dividends	-	(2) Reserve	-	(3) Accumulated Dividends	=	(4) Accumulated Deficit (-) or Surplus (+)
			Low Lapse				
1	$ -6.70		$ .27		$ 0		$ -6.97
2	8.97		13.02		1.25		-5.30
3	25.40		26.11		2.83		-3.54
4	42.80		39.56		4.99		-1.75
5	61.16		53.35		7.93		- .12
6	80.42		67.47		11.84		1.11
7	100.83		81.92		16.84		2.07
8	122.33		96.67		23.04		2.62
9	144.85		111.70		30.53		2.62
10	168.54		127.00		39.36		2.18

(continued on next page)

TABLE 19 (continued)

Ordinary Life

End of Policy Year	(1) Assets Before Dividends	-	(2) Reserve	-	(3) Accumulated Dividends	=	(4) Accumulated Deficit (-) or Surplus (+)
			Medium Lapse				
1	$ -7.89		$ .27		$ 0		$ -8.16
2	6.97		13.02		.75		-6.80
3	22.80		26.11		1.86		-5.17
4	39.78		39.56		3.58		-3.36
5	57.87		53.35		6.16		-1.64
6	77.06		67.47		9.80		- .21
7	97.58		81.92		14.68		.98
8	119.33		96.67		20.92		1.74
9	142.28		111.70		28.64		1.94
10	166.57		127.00		37.89		1.68
			High Lapse				
1	-9.57		.27		0		-9.84
2	4.11		13.02		.25		-9.16
3	18.91		26.11		.81		-8.01
4	34.99		39.56		1.91		-6.48
5	52.26		53.35		3.80		-4.89
6	70.81		67.47		6.68		-3.34
7	90.85		81.92		10.77		-1.84
8	112.27		96.67		16.26		- .66
9	135.04		111.70		23.32		.02
10	159.32		127.00		32.05		.27

TABLE 20

Ten Year Term

End of Policy Year	(1) Assets Before Dividends	-	(2) Reserve	-	(3) Accumulated Dividends	=	(4) Accumulated Deficit (-) or Surplus (+)
			Low Lapse				
1	$ -3.60		$ .01		$ 0		$ -3.61
2	- .55		.43		.50		-1.48
3	2.52		.81		1.55		.16
4	5.94		1.12		3.21		1.61
5	9.66		1.35		5.57		2.74
6	13.61		1.46		8.73		3.42
7	18.02		1.42		12.81		3.79
8	22.77		1.20		17.95		3.62
9	28.10		.74		25.00		2.36
10	35.14		0		35.22		- .08
			Medium Lapse				
1	-4.40		.01		0		-4.41
2	-2.37		.43		.25		-3.05
3	.02		.81		1.00		-1.79
4	2.95		1.12		2.34		- .51
5	6.43		1.35		4.42		.66
6	10.28		1.46		7.30		1.52
7	14.79		1.42		11.15		2.22
8	19.85		1.20		16.11		2.54
9	25.59		.74		23.07		1.78
10	33.23		0		33.36		- .13
			High Lapse				
1	-5.62		.01		0		-5.63
2	-5.39		.43		.10		-5.92
3	-4.74		.81		.28		-5.83
4	-3.83		1.12		.56		-5.51
5	-2.70		1.35		.97		-5.02
6	-1.22		1.46		1.51		-4.19
7	.68		1.42		2.20		-2.94
8	2.81		1.20		3.07		-1.46
9	4.53		.74		4.31		- .52
10	6.16		0		6.17		- .01

Observe that the policy is in a deficit position in its early years, regardless of lapse assumption. This is true for both plans. The depth and length of this deficit position is dependent on the lapse rates used, as expected. The higher the lapses the worse the financial position.

What we were discussing in Section B can be illustrated by looking at the Ordinary Life, "medium" lapse assumption set of figures. These say that at the end of the first policy year, the company (persisters) is holding a negative financial position (assets less liabilities) of $8.16 per thousand of insurance still in force. If one of the policies lapses at that point, the company (persisters) must absorb that loss. (The company's book loss is that $8.16 per thousand. The actual cash loss is equal to the assets less the cash value paid; and since in our illustrated case cash values equal reserves, or liabilities, the actual cash loss is the same $8.16 per thousand.) That affects the cost of the insurance to those who remain.

For balance, we should comment also upon the situation when the assets exceed the liability (reserve) held by the company. Consider the same Ordinary Life, "medium" lapse set but use the end of the 10th policy year. There the excess of assets over liabilities is $1.68 per thousand. That is the book gain for the company (persisters) for each thousand of insurance that lapses at that point. (It is also the actual cash gain since cash value paid is made to equal the liability, or reserve, held.)

Does this mean lapses can be "profitable" to the company (persisters)? Apparently, yes. When they occur in this situation there is a gain or profit from lapses. The real test is whether the assets belonging to the company are less than or greater than the cash value to be paid out. If they are less than the cash value, as they are in early policy years, there is a loss to the company (persisters); this is true even when the cash value is zero so long as the assets are then negative. If assets exceed the cash value, there is a gain to the company (persisters). To the extent assets equal the cash value there is no financial effect to the company (persisters) from a lapse.

While true, the preceding comments are admittedly somewhat oversimplified. There is a negative effect on the company, looking into the future, even when assets equal, or exceed, the cash value. This comes from such factors as:

- A smaller number of units are available to bear fixed overhead and administrative expenses. As policies lapse, there will be

fewer to bear these expenses and the resulting expense per policy would grow, clearly affecting the cost of insurance for persisters in a negative fashion.

- A deterioration in agent earnings, morale and eventually retention can occur as lapses rise. This would lead to increased expenses and thus a worsening of insurance cost.

- Assets might have to be held in a more liquid form than they would if there were no lapses, or at least if there was a substantially lower lapse level. This can occur particularly when investment returns on longer range investment commitments are at relatively high rates. Liquid assets earn, typically, a lower rate of return. Thus, the cost of insurance is increased through a lower overall interest rate that can be reflected in the pricing.

Each of these, and perhaps others such as those discussed in Section B, have an indirect or secondary affect on cost of insurance to the persisters. The total relationship of lapses to cost of insurance is a complex one.

H. A Word about Nonpar

With participating insurance, the impact of higher than assumed lapse rates is borne by the persisting policyowners (through reduced dividends). Conversely, if lapses are less than assumed, the persisting policyowners are rewarded with higher dividends and thus lower costs.

In the case of nonparticipating insurance, the company absorbs any differences plus or minus, in actual versus assumed lapse rates. The present block of policyowers is insulated from the differences, providing the company remains solvent.

However, variations in lapse rates can and do affect subsequent generations of nonparticiapting policyholders. If the company feels that the differences in lapse rates currently experienced will continue, they might be reflected as an adjustment in the premiums charged for new sales. Thus there is a translation of the effect of lapses into the cost of the product, albeit for the succeeding generation or block of buyers.

For all business, the lapse experience -- good or bad -- does reach the insurance-buying public. In participating insurance, the dividends adjust the cost to the policyowner. In nonparticipating insurance, a shift in lapse rates may cause higher (or lower) premiums for the new buyers.

I. The Answer

The "effect . . . lapses have on the cost of insurance for persisting policyowners" is measurable and is real.

The above examples do indicate that lapses indeed affect the costs for persisters (and lapsers while they're still with us). It is improper to generalize numerically from these examples. But they do illustrate the effect of lapses on cost of insurance.

CHAPTER V

WHAT IS EXTENT OF INJURY TO CONSUMERS?

The fifth question posed in the charge to the committee is:

> "What is the extent of injury to consumers where a high lapse rate exists?"

This chapter looks at this from each of several viewpoints.

One obvious and direct measure of the extent of the injury to the consumer when a lapse occurs is the outlay by the policyowner that will not be recovered. However, the system for the delivery of insurance to the consumer involves several groups. Agents, the individual companies, the industry as a whole and the regulatory agencies are all impacted by lapses. The cost of lapsation incurred by each of these groups must ultimately be borne by the consumer.

It is very easy to overlook the fact that a basic level of termination does exist. It is related to fundamental changes in the policyowner's economic and social status. It is the cost of lapsation above this basic level that we seek to identify and reduce.

The extent of the injury to the consumer is very difficult to quantify. To undertake a complete evaluation of the actual cost, if indeed it is possible, would be very expensive and time consuming. We know that lapses are costly and affect all parties involved in the business of insurance; with that knowledge widely held and accepted by all, we needn't attempt to quantify it too completely but rather address each of the groups incurring "costs" due to lapses.

A. Consumers

One criterion that has been used to measure the loss resulting from lapses has been based upon hindsight. If the policyowner (consumer) had taken out the insurance with the lowest initial price, irrespective of the type of need, temporary or permanent, he would have had a smaller loss upon termination. This is invariably true, at least in the early years of a policy.

In TABLE 21 we have shown the accumulated cost of a typical nonparticipating Annual Renewable Term policy at the end of the first and second years, and at the end of each fifth year. This is representative of the lowest cost that the policyowner could have incurred if he terminates early. We have contrasted the term result with results for a nonparticipating Ordinary Life policy.

The term insurance does provide a lower cost for early terminations (but might yield higher costs at longer durations). While this type of comparison is based upon hindsight and ignores the reason for purchasing insurance, it does indicate that there is a significant cost to the policyowner with an early termination. Had he or she known the insurance was going to be in force only a short time, the type of insurance purchased probably would have been the lowest premium plan available. Of course, that is indeed hindsight. (One even could push the point and say that now that the insured lived and didn't die in those, say, few years, he or she may know that no life insurance should have been purchased of any kind.)

This type of simple comparison is incomplete in that it compares unlikes. For example, the permanent policy will provide benefits related to the cash values that are not available in the term policy. Reduced paid-up or extended term insurance may be purchased with the cash values if the policyholder is forced to terminate premiums (for economic or other reasons), thus enabling the continuation of some amount of insurance protection. The cash values may also be used to provide retirement or other income if the policyholder's needs change.

TABLE 21

NOTE: The table accumulates at 5 percent interest the annual premiums for two $50,000 policies. The premiums for the Annual Renewable Term policy are typical of the rates currently available in the marketplace, usually only for policies with a high minimum size. The premiums and cash values for the Ordinary Life are for a nonparticipating policy and are also normally available only for higher minimum amounts.

End of Year	Nonparticipating Annual Renewable Term Accumulated Premiums	Nonparticipating Ordinary Life Policy Accumulated Premiums	- Cash Values	= Premiums Less Cash Values
		Issue Age 25		
1	$ 127	$ 526	$ 0	$ 526
2	259	1,077	0	1,077
5	699	2,904	1,524	1,380
10	1,601	6,610	4,652	1,958
15	2,855	11,340	8,367	2,973
20	4,776	17,377	12,665	4,712

(continued on next page)

TABLE 21 (continued)

End of Year	Nonparticipating Annual Renewable Term Accumulated Premiums	Nonparticipating Ordinary Life Policy Accumulated Premiums	- Cash Values =	Premiums Less Cash Values
		Issue Age 50		
1	$ 390	$ 1,554	$ 73	$ 1,481
2	834	3,186	1,222	1,964
5	2,554	8,587	4,764	3,823
10	7,198	19,546	10,919	8,627
15	15,319	33,533	17,268	16,265
20	29,253	51,384	23,694	27,690

In addition to the difference in cash outlay, measured with hindsight, the loss of life insurance benefits that otherwise might have been paid in the future is another type of injury to the consumer. The hardship suffered by the family when the breadwinner dies without adequate insurance is obvious and has been the subject of several studies. The portion of this loss that is due to the lapsing of a life insurance policy, while the need still exists, has not been studied; but it may be the most significant loss suffered by the consumer.

B. Agents

An agent who sells a life insurance policy is entitled to compensation for the service thus rendered to the policyholder and the company. The agent's compensation is primarily in the form of commissions, which are expressed as a percentage of the premium. When the policy lapses, the agent normally will suffer a reduction in income.

The pressure on agents' incomes created by high lapse rates is a factor contrbuting to agent terminations, particularly in the early years of an agent's intended career. The agent will rarely be able to survive if lapses are very high. When an agent terminates, additional lapses usually will be incurred on the business that agent wrote, and this further increases the cost associated with lapses.

Not only must an agent forego the commission that would have been received but, more importantly, the agent has lost a client, his or her most valuable asset.

Most companies have production clubs and recognitions which take persistency of business into consideration. An agent's disqualfication from such recognitions or from additional compensation based on a high persistency rate is a serious matter.

C. Company

The business of life insurance depends upon the sale of new policies, the retention of old policies, and the continuous flow of first year and renewal premiums on those policies. This string of premium payments, together with investment income, provides the funds that enable companies to pay claims and expenses. A policy which lapses early fails to pay its full share of acquisition and other expenses, and the balance must be borne by other policyowners. (See the numerical presentation and discussion of this in Chapter IV.) The company will prefer to keep the policy in force.

As discussed in Chapter IV, a company's lapse rate can have a significant effect on the competitive position of its products. In the case of participating insurance, it may influence both premiums and dividends. For nonparticipating insurance, lapses weigh heavily in the determination of the profitability of business and in the premium levels that must be set on subsequent blocks of business.

A policy which ultimately lapses subjects the company to additional direct expenses. Notices of impending lapse, late payment offers, reminders of reinstatement privileges, and the extra work involved in reinstatements, to name some related activities, all increase the operating costs.

To the extent that lapses contribute to agents' turnover, additional sums must be spent to recruit and train new agents in order to maintain an adequate sales staff. These outlays adversely affect the expense picture of a company and its competitive position.

D. Industry

There is no question but that a lapsed policy reflects adversely on the industry. Lapses give rise to unfavorable publicity and to accusations such as those from the investigations of Senator Hart's Committee (see Chapter I). Such adverse publicity makes for public wariness of life insurance.

A genuine concern with lapsation has existed for a long time, and this has motivated the industry to devote time and resources to the study of lapsation. These studies have been very helpful in aiding companies to identify and correct lapsation problems and should ultimately reduce the cost of lapsation.

E. Regulation

The impact of lapses carries over into the regulation of the insurance industry. The current concern and effort by the government, at the state and federal levels, is an example of indirect expenses incurred because of lapsation. The regulatory bodies are supported, either directly or indirectly, by premium taxes and,

theortetically, the tax rates are higher due to the impact of lapses.

Seldom will a policyowner who lapses assume the blame for the lapse and any losses connected therewith. He or she is much more likely to blame the agent for "high pressure selling," the company for "taking my money," the life insurance industry for selling something that wasn't needed or wanted, and the regulatory agencies for permitting this to happen. All groups are bound together with a genuine interest in reducing lapses to the lowest possible reasonable level, thereby reducing the injury to the consumer. The consumer bears the costs of lapses and, ultimately, the costs of efforts to minimize them.

CHAPTER VI

WHAT POSSIBLE SOLUTIONS MAY WE FIND?

The persistency of business is the concern of both the insurance industry and the regulators. The individual insurance companies and the insurance industry should, for their part, consider the suggestions for attacking persistency problems that will be given in this chapter. The regulators may want to consider the monitoring of lapse rates by the method presented in this report. As they work selectively with those companies which exhibit poor persistency, especially those in which such a showing is chronic, their work may involve suggestions given in this chapter.

A. Individual Company Approach

Before a company can remedy its persistency problem, it must first realize that it has such a problem, assess the extent and severity of the problem and then commit itself fully to its solution. It should continually monitor its own persistency rates and compare its rates with industry norms. Even if the overall persistency rate is acceptable, the company may wish to monitor individual agencies for persistency problems. In this case, individual agency persistency rates would be compared with company averages.

Companies with persistency problems at either the company level or the individual agency level have effectively attacked them in the following ways:

1. Compensation of field personnel

The fact that commissions are paid only as long as premiums are paid provides a strong incentive for the agent to keep a policy in force. This does not, however, prevent the agent

from writing a piece of business that he suspects may lapse after a short period of time. Companies have resorted to a wide variety of both positive and negative compensation elements in order to prevent the writing of lapse-prone business and to keep in force business already written.

Aside from the company's commission structure, the most common positive compensation element for agents is the persistency bonus. Companies having such an item of compensation vary widely in their methods of calculation. They may use early or long-term measures of persistency to determine the bonus percentage. The bonus percentage is applied to first year or renewal commissions, depending on company objectives or statutory considerations.

Companies paying noncommission compensation to agents, such as salaries in lieu of all or part of the commissions, often use the agent's persistency as an important criterion.

As a rather drastic example of a negative compensation element, some companies cancel and recover substantial portions of first year commissions already paid on policies that lapse before a certain period.

Such compensation elements may also be used for first line supervisors, agency managers, general agents, and even for personnel with responsibility for supervising agencies. Managerial overrides are often graded by persistency rate. In at least one company there is a persistency element in the compensation of field vice presidents.

2. Security benefits

At least one company which ordinarily provides noncontributory group life and health insurance for its full time agents requires a contribution from agents whose first year persistency falls below a certain level. (ERISA does not permit such a practice for pension benefits.)

3. Agents' honor clubs or conventions

There is, again, a variety of possible actions:

(a) Outstanding persistency can be converted to extra formula credit to assist agents with good persistency in qualifying.

(b) Agents below a certain first year persistency level can be barred from attending.

(c) Agents with outstanding persistency can receive special awards. These awards can be either on a par with awards for the top-producing agents or they can be less impressive than those awards.

(d) As with compensation, special recognition of persistency can and probably should take place at all levels of the field forces -- agent, first-line supervisor, agency manager, and superintendent of agencies.

4. Agent selection, training and supervision

Many companies give great emphasis in all their programs of recruiting, training and supervising agents to all aspects relating to good persistency. Such companies encourage their agents to sell quality business, to sell new business in such an effective fashion that it stays sold, and to take all necessary steps to conserve business when problems arise. The company's philosophy of quality business is obvious in selection interviews and permeates the entire organization in all other activities.

5. Termination of agents

Some companies actually go so far as to terminate agents whose persistency is unsatisfactory. For example, one company's agent training allowance plan automatically fails an agent who cannot maintain a 75 percent first year persistency rate. Just as most companies have a production requirement that the agent must meet to maintain his contract, it is certainly appropriate to consider a persistency requirement as a regular contract provision.

6. Use of persistency raters

A persistency rater is a device that predicts the likelihood of early lapse of a policy. The typical factors used in making this prediction include mode of premium payment, age and income of the insured and the insured's previous ownership of life insurance. One such rater commonly used in the industry assigns scores ranging from 4 and under for a policy with a very high probability of early lapse up to 9 for a policy with a very low probability of early lapse. These raters have been developed by individual companies and by the industry based on studies correlating the characteristics of business issued with actual persistency. (See Chapter III for a discussion of the relationship of such characteristics to persistency.)

Such a rater may be used to obtain a quantitive measure of the quality of business of an agent or a group of agents. It

provides a basis for special supervision of such agents, as is noted in the next section. A company may also apply a rater to all its issued business to provide a quantitative measure to be used for persistency studies.

7. Special supervision

Some companies have lists of agents with poor persistency and carefully monitor their new business applications. The monitoring may be done by the use of a persistency rater.

Other companies apply closer monitoring of the persistency of new agents. The critical period of the agent's career can be considered to be something like the first 90 days, and such companies may use early warning systems to detect patterns of probable persistency problems with these new agents. Again, a persistency rater would be useful in such an effort.

The practice of at least one large company in the underwriting area should be mentioned here. Certain agents who exhibit good field underwriting capabilities, as evidenced by an appreciable and appropriate volume of production and good persistency, are allowed higher limits on their nonmedical business.

8. Reduced emphasis of modes of business with poor persistency

Regular monthly mode of premium payment has less favorable persistency than the other premium notice modes. Most companies experience better persistency with the bank check plans and salary savings plans, but this is not necessarily the case for all companies.

There is a wide range of action that a company may take in this area:

(a) A company may refuse to write or may limit the amount of monthly mode for all or part of its agency force. For instance, it may allow only agents past the training period to write unrestricted amounts of monthly business.

(b) A company which annualizes first year commissions for its bank check plan may discontinue this practice for agents or groups of agents with poor persistency. For example, one company does not annualize bank check plan business for its agents under training allowance plans.

(c) Other companies charge back all or most of the commission in the event of a first year lapse.

(d) Finally, if contracts are sold on the monthly mode, it is possible to withhold commissions until the policyowner has made two or three premium payments.

9. Home office systems

The home office systems should be geared to respond to delayed premium payments, cash surrender requests and lapses. Most companies automatically inform the agent or agency of a request for cash surrender values; when the policy actually lapses they send out lapse notices together with letters seeking reinstatement. Such action on the part of the home office and the agent would avoid almost all unintentional lapses.

An effective device that makes the agent aware of the direct impact of lapses on his compensation is to list on his commission statement what his earnings would have been had none of his policies lapsed in a given period.

10. Education of new and existing policyowners

The policy should always be delivered by the agent, who should review the reasons for purchase with his or her client. The methods of doing this should be an integral part of the training program.

Existing policyowners could be kept aware of the importance of keeping their policies in force by means of "stuffers" in their premium notices.

11. Efforts in the home office

Companies often make a study or a survey of their lapsed business in an effort to determine the reasons for lapsation. A different approach would be to perform a buyer study to identify the characteristics of persistent business.

Companies often designate a home office persistency officer and/or form a persistency committee, either to maintain good persistency or to study persistency problems and their solutions. Such a person or committee must stay in tune with industry trends and be up-to-date with industry practices in the area of persistency improvement. A wealth of information for guidance in this area is contained in LIMRA's Quality Business Officer.

12. "Jawboning"

There are several possible activities under this general heading:

(a) Speeches and continued emphasis from key company people on the importance of reducing lapse rates are procedures used by many companies.

(b) Companies may also establish goals for persistency improvement along with their goals for sales increases for the next calendar year.

(c) Any publications for field personnel may also include a continual flow of articles on persistency improvement as well as the financial rewards for good persistency.

The preceding ideas are some that may be implemented by a company embarked on a persistency improvement program. It is hoped that these ideas will generate others.

Readers who are interested in a more comprehensive volume of persistency improvement measures currently undertaken by companies in the industry are directed to the LIMRA library as a source and to the ideas already generated by LIMRA's Quality Business Committee.

B. Industry Approach

The industry as a whole has already taken steps to recognize and encourage the writing of persistent business.

1. Two industry organizations, the National Association of Life Underwriters and LIMRA, are sponsors of the National Quality Award. This annual award, initiated in 1944, is designed to bring attention and honor to those life and health field underwriters who have excelled in their profession by selling quality business as reflected by a high persistency standard -- i.e. a minimum of 90 percent first year persistency.

2. The Chartered Life Underwriter (CLU) association, a professional organization of life insurance agents, requires high standards for membership and encourages the writing of quality business. High persistency is a characteristic of business produced by CLU's; each year a very high percentage of CLU's earn the National Quality Award.

3. Quality Business Seminars -- that is, seminars, workshops and general sessions dealing with the persistency of business and the causes and effects of good and poor persistency -- are normally a part of the programs of LIMRA, LIMRA's Quality Business Committee, the Society of Actuaries, American Council of Life Insurance, National Association of Life Underwriters, Million Dollar Round Table and other industry organizations.

4. The industry, through its trade associations (LIMRA and the American Council of Life Insurance), supports the collection and analysis of lapse rates in the aggregate, by company, geographical area, buyer and policy characteristics. It supports a wide variety of research activities into the nature of both short- and long-term lapsation.

The industry, through its various organizations, does undertake various programs of persistency improvement that would aid individual companies having persistency problems.

CHAPTER VII

A DISCLOSURE SYSTEM

A procedure is being sought by the NAIC whereby companies with unusual persistency patterns readily may be identified through data to be published in their annual statement. Of particular interest are those companies which exhibit substantially poorer than normal persistency experience.

It is recognized that variations in persistency will occur because of different markets companies serve or as a consequence of the mix of business (issue age, policy duration, etc.) currently on a company's books. Any disclosure formula should, on the one hand, properly weigh factors to provide a reasonable answer as to the true level of a company's persistency and, on the other hand, not require excessively difficult calculations or recordkeeping procedures. A balance between the two is needed.

Consideration was given initially to developing a disclosure formula using data currently published in the annual statement. However, it readily became apparent that annual statement data are not in a form, nor do they include information, that permits proper evaluation of lapse rates:

1. The statement is published before final determination can be made of all lapses chargeable to the year covered.

2. There are a number of definitional differences between what is included in the annual statement and what should be considered as a lapse; e.g., in the annual statement, a policy which goes on extended term insurance is not considered a lapse until the term expires. This differs from traditional lapse rate philosophy.

3. Most importantly, without any breakdown of the inforce, it is impossible to examine the impact of policy duration on lapse. This is an important factor affecting company persistency which will be discussed more in this chapter.

Under the proposed disclosure formula described below, more data collection may be required of some companies than they are now doing. The amount of recordkeeping that is needed to support the suggested formula is, in our estimation, the minimum in which a company should be engaged. Any company with a serious persistency problem should perform even deeper analyses, and details more extensive than our proposal hence will be necessary. Hopefully, the system will encourage going beyond mere disclosure and will aid companies in improving overall persistency.

A. Reasons for the Choice of Formula

Chapter III lists a number of specific factors affecting persistency. Some relate to policyholder characteristics; others are within the control of a company. And from experience we do know that there tend to be variations in persistency in accordance with the markets in which companies operate. While it is possible for a company to refuse to sell policies in those markets where persistency tends to be low (e.g., to young adults or those with lower income), it is not our purpose to suggest through a disclosure system that the availability of insurance to any class of applicant be limited. Neither do we feel that a disclosure formula, as constructed, should contain rationale as to why a company's level of persistency is what it is. Rather, the main purpose of a disclosure procedure should be to supply basic, factual information which, when interpreted properly, will offer a broad perspective on a company's persistency.

In our view, differences in markets served or mixes of business in force should be recognized in the formula only in the broadest terms. The position can be taken at the outset that various factors, such as age at issue or mode of premium payment, inherently affect persistency levels; and, accordingly, we could adjust the disclosure formula so as to "wash out" these effects. What do we mean by "wash out"? A hypothetical example here may be helpful in illustrating the point.

Suppose Company A has 1000 policies in force and lapses 65 in one year; its lapse rate would be 6.5 percent (65 ÷ 1000). Suppose further that Company B has 500 policies in force and lapses 52; its lapse rate would be 10.4 percent (52 ÷ 500). In this highly simplified example, a direct comparison of actual lapse rates can be made between the two companies to arrive at a conclusion as to their relative levels of persistency. However, in more formal fashion, the comparison may be made to industry norms as shown in TABLE 22 on the next page.

In this table, we have assumed an aggregate industry standard lapse rate of 5 percent for all business combined. We have multiplied this rate by the inforces of each company to derive "expected" numbers of lapses for each. An actual to expected ratio is then determined for each company. Their ratios then can be compared.

TABLE 22

(1) Industry Standard Lapse Rates	(2) In Force	(3) Actual Lapses	(4) Expected Lapses = (1) x (2)	(5) Actual to Expected Lapse Ratio = (3) ÷ (4)
		Company A		
.05	1,000	65	50	1.30
		Company B		
.05	500	52	25	2.08

Company A could say, "We have a better lapse picture than Company B." The data shown in TABLE 22 might suggest that. However, Company B, knowing something about their mix of business, might say, "No, if our different mixes of business by duration are properly recognized, you'll find we are doing a better quality job." The fact is, the TABLE 22 calculations treat the entire business of each company as a totality and do not adequately reflect durational variations. Company B in its view of the situation is suggestng a "washing out" (normalization) of the effect of duration, as shown in TABLE 23.

The industry standard lapse rates as well as the inforces and lapses for each company in TABLE 23 are separated into first year and renewal components. When expected lapses are determined separately for each durational category, it can be seen that the total expected lapses for each company differ markedly from that in TABLE 22. The actual to expected lapse ratios tell a different story in TABLE 23 from the one in TABLE 22, and the conclusions to be drawn are more valid. The actual to expected ratio for Company A is worse than it was in TABLE 22; the ratio for Company B is better; and, in fact, the conclusion is that Company B now looks better than Company A.

TABLE 23

Policy Years	(1) Industry Standard Lapse Rates	(2) Inforce	(3) Actual Lapses	(4) Expected Lapses = (1) x (2)	(5) Actual to Expected Lapse Ratio = (3) ÷ (4)
		Company A			
1st year	.17	100	20	17	1.18
Renewal	.03	900	45	27	1.67
Total		1,000	65	44	1.48
		Company B			
1st Year	.17	200	28	34	.82
Renewal	.03	300	24	9	2.67
Total		500	52	43	1.21

An analysis of the TABLE 23 results would indicate Company A is a mature company because of its high proportion of renewal inforce to total inforce. Company B is probably a newer company inasmuch as its renewal inforce is a relatively low proportion of its total inforce. It is this mix of business phenomenon that can cause substantial differences in actual to expected lapse ratios, depending on how the components making up the totality are treated.

Besides duration, other factors which affect persistency could similarly be recognized and washed out as normal market or mix of business variations. These might include mode of premium payment, issue age, sex, occupation, income of insured, underwriting classification, agents' length of service, etc. However, to do so would be to prejudge what may or may not be valid reasons for unusual levels of persistency. In our view, it would be both impractical and improper to wash out the impact on company lapse rates of the vast majority of such factors by their recognition in the structured disclosure formula. We leave any explanation of unusual persistency experience that may be triggered by a simple, straightforward disclosure approach for later and deeper analyses of circumstances. An example of such additional analysis is contained in EXHIBIT 6 at the end of this report.

We suggest only a minimum number of distinctions be made in the structured disclosure formula:

1. Because there is special regulatory concern with lapse rates of cash value versus term insurance, we suggest a subdivision between these products.

2. Within cash value insurance, we believe the system should isolate debit ordinary, regular ordinary and individual pension trust business as representing major market divisions of disparate nature requiring separate treatment(1).

3. We know persistency is affected appreciably by the period of time business has been in force. Thus, to reflect equitably durational inforce differences that can exist among companies (e.g., newer companies as opposed to established ones or companies with volatile issue patterns), several policy duration groupings are also suggested.

In all, there would be 24 categories for which data would be reported, as shown in TABLE 24 below.

TABLE 24

	Cash Value Insurance			All Term Insurance
Policy Years	Regular Ordinary	Debit Ordinary	Pension Trust	
1				
2				
3-5				
6-10				
11+				
All				

(1) If the amount of pension business sold by a company is 5 percent or less of its total, the company would have the option of combining pension with regular ordinary business.

B. Disclosure Formula

Our proposed formula would be applied separately to each of the four major blocks of business in TABLE 24. Actual to expected lapse ratios are the only data that would be shown in such a table. These ratios would be determined individually for each of the five durational groupings (1, 2, 3-5, 6-10, and 11 and over). The durational groupings would then be combined by a "normalization" procedure into an all-duration actual to expected lapse ratio.

To obtain the actual to expected ratios:

1. Industry standard lapse rates would be obtained for each of the 20 categories in TABLE 24, excluding the all-durations line of the table.

2. The company's inforce for each of the 24 categories would be determined.
   (Note: The inforce for the all-durations line of the table is not needed but can be obtained easily and shown for informational purposes.)

3. Actual company lapses would be determined for each of the 20 categories, excluding the all-durations line of the table. These would be summed to produce the actual lapses for the all-duration categories.
   (Note: the exposure period would be either a calendar year or would follow policies from anniversaries in one year to anniversaries in the next year, at the option of the company.)

4. The industry standard lapse rate for each of the 20 categories would be applied to the company's inforce for that category. This produces expected lapses for each category. They would be summed to produce the expected lapses for the all-duration categories.

5. The ratio of actual lapses to expected lapses would be determined for each of the 24 categories. This would be done by taking the ratio of actual lapses to expected lapses, calculated in 3 and 4 above, for each category.

An example of how the formula works follows in TABLE 25. The example uses a single type of product (i.e. column out of TABLE 24); the method is equally applicable to any of the four types. Column numbers relate directly to the numerical steps outlined above.

TABLE 25

Policy Years	(1) Industry Standard Lapse Rates	(2) Inforce	Type of Product (3) Actual Lapses	(4) Expected Lapses = (1) x (2)	(5) Actual to Expected Lapse Ratio = (3) ÷ (4)
1	.17	100	20	17	1.18
2	.09	80	9	7	1.29
3-5	.06	200	14	12	1.17
6-10	.04	200	10	8	1.25
11+	.02	420	13	8	1.63
All	xxx*	1,000	66	52	1.27 (= a normalized ratio)

*Don't obtain or use, for such an overall rate for all durations is meaningless at best and misleading at worse.

The actual to expected lapse ratios in column (5) would be entered into the appropriate column of TABLE 24.

Industry standard lapse rates to be used would be established by an independent organization, such as LIMRA. They would be made available to companies, either directly, after NAIC sanction, or through the NAIC central office.

While it would be possible to continue this procedure so as to further normalize and combine the four major product lines into a single index, we suggest this not be done. To do so would mask the results of four disparate blocks of business.

C. Definitions of Data

The following are recommended definitions of the data to be included in the determination of lapses and exposures. The list is not intended to be exhaustive but to cover major questions likely to be asked. It is recognized that companies handle data in a variety of ways and, therefore, some leeway on data content may be needed.

Any variations from prescribed procedures should be such as to produce only negligible differences in the overall results. From year to year, the methods and procedures used by a given company to obtain data and calculate actual to expected lapse ratios should be consistent, changing only for good and sufficient reason.

1. Lapsation is to mean termination by lapse, surrender or application of reduced paid-up or extended term options. Non-renewal of renewable term insurance is also considered a lapse. The lapsation of a term policy due to conversion to permanent insurance should not be considered a lapse, nor should death, maturity or expiry at the end of the term coverage.

2. Lapses are assigned to the last policy year for which any part of the premium is paid.

3. Policy year lapses and related inforces are to be determined by face amount for designated durations by an accepted method, of which there are several.

4. Exposures would be for either a particular 12 month period or between policy anniversaries in one 12 month period and policy anniversaries in the next 12 month period. Thus, the exposure period covered for annual statement year z (to be submitted early in calendar year z+1) would be either calendar year z-1 or policy anniversaries in calendar year z-2 traced to policy anniversaries in calendar year z-1.

5. Group conversions should be excluded from the calculations.

6. Partial surrenders should be included as lapses for the amount of insurance reduced. Policy plan changes should be considered as lapses only to the extent that the amount of insurance decreases.

7. Scheduled changes in coverage may be leveled by using an average amount.

8. Lapse data is to apply to premium paying policies only.

9. Term riders attached to permanent plans are to be treated as term insurance.

10. Policies with preliminary term coverage for less than one year should not be included in the calculations during the preliminary term period.

11. Revivals should be handled by each company in a manner consistent with how it determines its lapses.

D. Reporting Form

The entire TABLE 24 would be included in the annual statement on something like page 17 or 17A, the general interrogatories. Each company should have on file sufficiently detailed back-up data to support the ratios displayed in TABLE 24 and be prepared to submit them to the commissioners of insurance on request. Companies may wish to prepare more extensive subdivisions of their business either to explain deviations from the norm or to study areas needing further attention. The material presented in Chapter III should prove helpful in selecting factors for study.

E. Industry Aggregates

Concurrent with the establishment of this reporting system, companies may be asked to submit the raw data that supports their TABLE 24 displays to a central source (perhaps LIMRA or the NAIC central office). This organization would aggregate the information to assist in developing industry standards as well as other statistical information.

SUMMARY

This summary provides a brief overview of the material in each chapter of the report. While readers are encouraged to read the whole report, because of its length some may be unable to do so. We hope this summary will lead the reader to areas of greatest interest.

There are several purposes of the report: to provide background information regarding lapses (Chapters I and II); to indicate factors related to lapse (Chapter III); and to illustrate the effect of lapse on costs and benefits (Chapters IV and V). In addition, the report suggests some ways to improve lapse rates (Chapter VI) and offers a disclosure system for inclusion in the annual statement which will provide greater awareness of company persistency and which may supply impetus for companies to act more positively in this area (Chapter VII).

Chapter I: IS THERE A LAPSE PROBLEM?

The committee's charge began quite reasonably with the above question. The committee feels that "there is a lapse problem, in the sense that: we wish fewer policies terminated in lapses; we recognize those harmed by lapsation include the buyer, lapser, persister, industry, agent, company and beneficiary; and we belive improved persistency, to the advantage of all, can be achieved, although not easily."

In answering this question with a "yes", the committee considered the perspective and/or statements of six groups of interested persons:

1. Insurance Industry. The industry has for many years monitored lapse rates and made efforts to improve persistency, indicating that it feels the situation is worth improving.

2. National Association of Insurance Commissioners. They have for many years expressed interest in and concern about policy lapsation.

3. U.S. Senate's Hart Committee Hearings of 1973-4. Concern, particularly about high early lapse rates, was expressed many times.

4. Federal Trade Commission. Their 1978 questionnaire, sent to about 100 life insurance companies, has some questions about lapse rates.

5. Individual Critics. Many have criticized the industry about lapse rates, although frequently in an ill-defined way.

6. Individual Policyholders. This group, although significantly affected by lapses, has not spoken on this issue.

The committee believes that, since several groups feel there is a problem, there is reason for concern and that something can be done to improve the situation. However, all concerned realize that, while reasonably low lapse rates are desirable, the total lack of lapse is neither possible nor necessarily desirable.

CHAPTER II: HOW EXTENSIVE IS THE LAPSE PROBLEM?

The chapter first attempts to correct the general impression held by some, that early lapse rates have doubled over the last 25 years. Actually the trend has been fairly stable with some cyclical variations, and there are indications lapse rates are currently at a low point.

Concern about lapses centers around the substantial variation in lapse rates among companies. However, great care must be taken in interpreting lapse rates because companies may operate in different markets and write business with different characteristics. Further, the extent of these differences may vary from year to year.

This chapter as well as Chapter III (What Are Factors Affecting Persistency?) and Chapter VII (A Disclosure System) provide some insight into the analysis of lapse rates.

CHAPTER III: WHAT ARE FACTORS AFFECTING PERSISTENCY?

Numerous factors may affect persistency. The two factors cited as most important are mode of premium payment and income of the insured. Major factors considered are:

A. Buyer Related Factors - income, age, occupation and sex of the insured, and whether the insured has previously purchased insurance in the same company.

B. Product Related Factors - mode of premium payment, type of policy (term or permanent, high early cash values, pension), amount of annual premium and type of underwriting.

C. Agent Related Factors - agent's length of service at the time of sale, ultimate survival in the business and insurance knowledge.

D. Post-Sale Related Factors - changes in the insured's financial condition, in the insured's perception of his financial priorities and in the economy - also the effects of policy loans and replacements.

CHAPTER IV: WHAT IS EFFECT ON COST OF INSURANCE?

This chapter focuses on the effect that lapses have on the cost of insurance for persisting policyholders. For participating business, mathematical models are used to illustrate the effect lapses have on annual dividends and interest-adjusted costs. Effects on nonparticipating premiums are also discussed. In addition, the chapter discusses the marginal effects which lapses have on an insurance company, as well as important secondary effects.

Mathematical models for a participating Ordinary Life policy and a participating Ten Year Term policy issued to a male age 30 are developed. The results indicate that higher lapse rates produce higher costs. Representative results are shown below:

TABLE 26

		Lapse Experience		
		Low(=None)	Medium	High
	Ordinary Life			
Equivalent Level Annual Dividend	10 Year	$ 2.88	$ 2.54	$ 2.01
	20 Year	5.48	5.26	4.86
Surrender Cost Index	10 Year	6.11	6.44	6.97
	20 Year	4.68	4.90	5.30
	Ten Year Term			
Equivalent Level Annual Dividend	10 Year	$ 1.83	$ 1.44	$ .18
Surrender Cost Index	10 Year	3.77	4.16	5.42

In the case of nonparticipating insurance, once a policy is issued the company absorbs any effects on cost which are generated by lapses. Existing policyowners are, therefore, insulated from these effects as long as the company remains solvent. Future policyowners will be affected if premium changes become necessary.

In summary, this chapter concludes that the effect lapses have on the cost of insurance is measurable and real.

CHAPTER V: WHAT IS EXTENT OF INJURY TO CONSUMERS?

The primary purpose of life insurance is to provide protection against economic loss at death. While the need may be temporary or permanent, when a policy lapses before the need expires the policyowner generally loses.

Policyowners may be injured both directly and indirectly by lapses. The direct effects include the policyowner's outlay and lost benefits for beneficiaries. Indirect effects arise from agent turnover, loss of company and industry reputation, and increased regulation.

CHAPTER VI: WHAT POSSIBLE SOLUTIONS MAY WE FIND?

A life insurance policy which is properly sold and serviced generally should persist. This chapter lists actions which may be taken by companies and the insurance industry to promote improved persistency, particularly through efforts to improve the sale and post-sale service. Most of the practices listed below are already used in one form or another by companies:

1. Compensation of field personnel
2. Security benefits
3. Agents' honor clubs or conventions
4. Agent selection, training and supervision
5. Termination of agents
6. Use of persistency raters
7. Special supervision
8. Reduced emphasis on modes of business with poor persistency
9. Home office systems
10. Education of new and existing policyowners
11. Efforts in the home office
12. "Jawboning"

Several industry-wide, coordinated efforts are also cited.

While many of the approaches described in this chapter may help to improve persistency, a company must first recognize that a problem exists, then assess the extent and severity of it and, finally, then commit itself fully to its solution. Companies should regularly monitor their own lapse rates.

CHAPTER VII: A DISCLOSURE SYSTEM

As a result of the NAIC's request, the committee has developed a disclosure system designed to identify companies with unusual persistency patterns. The proposed disclosure formula should provide a reasonable indication of the level of a company's persistency while not requiring unusually difficult calculations or recordkeeping procedures. Selected company lapses, based on the experience of a recent 12 month period, would be compared against an industry standard, and the actual to expected lapse ratios would be disclosed in the annual statement.

Variations in persistency can occur because of different markets which companies serve or as a consequence of the mix of business (age, duration, etc.) currently on a company's books. The committee realizes that variations in lapse experience are influenced by a number of factors not recognized in the suggested disclosure system, an important one being mode of premium payment. However, the disclosure system suggested attempts to avoid undue complexity and reflects differences in markets served only in broad terms.

Because there is special regulatory concern with lapse rates of cash value insurance, we have suggested showing cash value and term insurance separately. For cash value insurance, regular ordinary, debit ordinary, and pension trust business are separated. For term insurance, including term riders, no separation is suggested. Several policy duration groups are also suggested to reflect different mixes among companies. In total there would be 24 categories as shown in the table below:

TABLE 27

Ratios of Actual Lapses to Industry Standard Lapses

Policy Years	Cash Value Insurance			All Term Insurance
	Regular Ordinary	Debit Ordinary	Pension Ordinary	
1	_____	_____	_____	_____
2	_____	_____	_____	_____
3-5	_____	_____	_____	_____
6-10	_____	_____	_____	_____
11+	_____	_____	_____	_____
All	_____	_____	_____	_____

Lapse and exposure determination would be based on any of a number of acceptable methods. In general these methods would cover lapses and exposures for either during a particular 12 month period or between policy anniversaries in one 12 month period and policy anniversaries in the next 12 month period. This would require reporting so that, for example, the 1979 annual statement data (published early in 1980) would be based on lapses occurring during periods which might include 1977 or 1978. Further, in order for companies to have adequate time to gear up for this disclosure system, such disclosure probably should not begin until at least three years after the system is adopted.

EXHIBIT 1

QUESTIONNAIRE NO. 1, QUESTION 31 OF FEBRUARY 8, 1973

Question 31.—"First year lapse rate for 1972 based on the LIAMA formula" (which is based on volume or face amount), as reported to the Senate Antitrust and Monopoly Subcommittee by the companies.

Company	LIAMA lapse rate (percent)	Company	LIAMA lapse rate (percent)	Company	LIAMA lapse rate (percent)
Aetna	19.3	Interstate Life and Accident [4]	[1] 41.8	New England Mutual [18]	[19] 13.9
American Heritage	27.5	Jefferson National	[6] 19.7	Northwestern Mutual	8.0
American General	12.0	Jefferson Standard	[7] 13.8	Northwestern National	15.9
American National	33.0	John Hancock	[8] 23.1	Occidental (California)	[20] 16.5
American United	17.6	Lafayette	[9] 19.7	Pacific Mutual	21.7
Bankers Life (Iowa)	17.6	Lamar	28.3	Penn Mutual	18.4
Central	[1] 13.0	Liberty Life	25.0	Phoenix Mutual	13.4
Coastal States	23.8	Liberty National	28.0	Provident Life and Accident	11.6
Combined Insurance Co.[2]	34.8	Lincoln National	[10] 17.1	Provident Mutual	13.8
Confederation	11.2	Massachusetts Mutual	10.8	Prudential	[21] 17.5
Connecticut General	14.0	Metropolitan	[11] 25.0	Republic National	[22] 26.3
Connecticut Mutual	13.1	Monumental [12]	23.6	Southland	20.2
Equitable Life Assurance Society	20.7	Monumental [13]	39.1	Southwestern	15.0
Farmers New World	22.8	Monumental [14]	35.7	State Farm [23]	[24] 20.7
General American	13.6	Mutual Benefit	[15] 13.0	State Mutual	14.1
General Services	12.8	Mutual Life of New York	18.3	Travelers	23.0
Georgia International	21.0	National Life	11.3	Union Central	21.0
Hamilton National	15.1	National Life and Accident [16]	39.5	United Benefit	22.0
Home	[3] 13.4	Nationwide	[17] 30.7		
		New York Life	19.7	Industry average	17.2

[1] 14.9 percent, as reported by LIAMA.
[2] Monthly debit ordinary business.
[3] 12.8 percent, as reported by LIAMA.
[4] Combination company (ordinary and debit business).
[5] 62.1 percent, as reported by LIAMA.
[6] For 1971.
[7] 14.8 percent, as reported by LIAMA.
[8] 23.6 percent, as reported by LIAMA.
[9] 19.1 percent, as reported by LIAMA.
[10] 16.3 percent, as reported by LIAMA.
[11] 25.9 percent, as reported by LIAMA.
[12] Premium notice business only.
[13] Monthly debit ordinary business only.
[14] Total ordinary business.
[15] 13.7 percent, as reported by LIAMA.
[16] Combination company (ordinary and debit business).
[17] 29.0 percent, as reported by LIAMA.
[18] Published mid-year 1972.
[19] 12.7 percent, as reported by LIAMA.
[20] 18.9 percent, as reported by LIAMA.
[21] 19.3 percent, as reported by LIAMA.
[22] For 1971.
[23] As of June 30, 1972.
[24] 19.6 percent, as reported by LIAMA.

LIFE INSURANCE QUESTIONNAIRE NO. 1, QUESTION 33

33. Submit an analysis of terminations based on a radix of 100,000 straight life insurance policies issued to males age 35. Please use the following column headings in the analysis, and carry the analysis to age 100.

Policy Year	Attained Age Beginning of Year	(1) Number of Policies in Force Beginning of Year	(2) Probability of Death	(3) Probability of Withdrawal	(4) Number of Policies Terminating by Death in Year (1)x(2)	(5) Net (1)-(4)	(6) Number of Policies Terminating by Withdrawal in Year (3)x(5)	(7) Number of Policies in Force at End of Year (5)-(6)

(continued on next page)

EXHIBIT 1 (continued)

SUMMARY OF ANALYSIS OF TERMINATIONS BY LAPSATION BASED ON A RADIX OF 100,000 STRAIGHT LIFE INSURANCE POLICIES TO MALES AGE 35*

Company	Of initial 100,000 policies, cumulative percent[1] lapsed at end of year— 1	2	10	20	30
Aetna	15	22	42	53	62
American General	10	17	46	62	73
American Heritage	28	38	64	77	85
American National	24	30	54	66	73
Bankers (Iowa)	20	27	47	61	71
Central Life Assurance	13	17	32	41	47
Combined (MOD)	29	38	53	69	79
Confederation (Can.)	5	19	59	70	80
Conn. General	11	18	38	52	64
Conn. Mutual	16	21	38	50	58
Crowe (Can.)	9	14	34	45	54
Equitable Assur. Society	19	25	47	60	69
Farmers New World	29	38	59	70	78
Fidelity Union	34	50	68	78	NA
General American	17	24	44	56	64
General United	20	30	50	73	82
Georgia Inter.	18	29	61	75	84
Hamilton National	22	32	63	76	84
Home	10	15	37	49	58
Interstate Life and Acc.	30	47	64	72	77
Jefferson Standard	15	21	40	53	65
John Hancock	28	38	52	63	69
Lafayette	20	28	45	55	59
Lamar (one-par)	22	24	38	46	51
Liberty Life	23	31	54	66	74
Liberty National	28	38	59	70	78
Lincoln National	18	24	46	59	70
Mass. Mutual	5	9	30	44	55
Metropolitan	19	26	48	58	66
Minnesota Mutual	12	17	45	62	72
Monumental (Prin. Nat.)	29	36	59	69	73
Monumental (MOD)	31	43	57	64	68

Company	Of initial 100,000 policies, cumulative percent[1] lapsed at end of year— 1	2	10	20	30
Mutual Benefit (N.J.)	7	13	43	57	67
Mutual of N.Y.	18	24	48	60	69
National Investors	20	30	64	78	83
National Life and Accident	26	35	59	69	76
National of Vermont	10	14	32	47	58
National Old Line	20	28	46	58	66
Nationwide	25	33	52	63	70
New England Mutual	10	16	40	51	61
New York Life	19	23	45	57	68
Northwestern Mutual	6	8	21	34	45
Northwestern National	20	26	47	58	66
Occidental (Calif.)	18	24	38	48	58
Ohio State	29	37	62	75	83
Pacific Mutual	22	28	46	58	64
Penn Mutual	22	30	49	56	67
Phoenix Mutual	15	22	46	58	71
Pilot	15	21	42	54	66
Provident Life and Acc.	9	17	44	59	67
Provident Mutual	13	17	37	49	58
Prudential	10	19	44	51	55
Republic National	15	24	58	73	78
Southland[2]	20	29	47	61	71
Southwestern	10	15	29	42	53
State Farm	18	28	43	51	59
State Life	20	28	50	63	73
State Mutual[3]	9	15	41	55	63
State Mutual[4]	6	11	31	42	50
Travelers	19	25	48	60	71
Union Central	25	30	48	62	72
United Benefit	22	32	58	69	76
Western and Southern[5]	17	27	52	61	67

*Derived from company responses to life insurance questionnaire No. 1 (Feb. 8, 1973) question 33. Although terminations by death were included in question 33, they have been excluded in this particular analysis.
[1] Rounded.
[2] Ordinary business only; "executive preferred" excluded.
[3] Regular straight life business.
[4] Noncigarette smoker straight life policy.
[5] Premium notice, debit business.
NA—not available.

TABULATION OF RESPONSES TO LIFE INSURANCE QUESTIONNAIRE NO. 1, QUESTION 33

AN ANALYSIS OF TERMINATIONS BY LAPSATION BASED ON A RADIX OF 100,000 STRAIGHT LIFE INSURANCE POLICIES ISSUED TO MALES AGE 35

Policy year	Attained age at beginning of year	Number of policies in force at beginning of year	Probability of withdrawal (lapse)	Number of policies lapsing in year	Number of policies in force at end of year	Cumulative number of policies lapsed at end of year 1, 2, 10, 20, and 30
AETNA						
1	35	100,000	0.15	15,000	85,000	15,000
2	36	85,000	.077	6,545	78,455	21,545
10	44	59,484	.025	1,487	57,997	42,003
20	54	47,362	.02	957	46,905	53,095
30	64	39,091	.02	782	38,309	61,691
AMERICAN GENERAL						
1	35	100,000	0.10	10,000	90,000	10,000
2	36	90,000	.075	6,750	83,250	16,750
10	44	56,006	.035	1,960	54,046	45,954
20	54	39,220	.035	1,373	37,847	62,15
30	64	27,465	.035	961	26,504	73,493
AMERICAN HERITAGE LIFE OF FLORIDA						
1	35	100,000	0.275	27,500	72,500	27,500
2	36	72,500	.120	8,700	63,800	36,200
10	44	37,222	.050	1,869	35,427	64,800
20	54	24,028	.04	961	23,067	76,933
30	64	15,974	.04	639	15,335	84,665
AMERICAN NATIONAL						
1	35	100,000	0.2394	23,900	76,100	23,900
2	36	76,100	.086	6,545	69,555	30,445
10	44	48,236	.037	1,784	48,452	51,548
20	54	35,753	.025	894	34,859	65,141
30	54	28,107	.023	658	27,449	72,551

Policy year	Attained age at beginning of year	Number of policies in force at beginning of year	Probability of withdrawal (lapse)	Number of policies lapsing in year	Number of policies in force at end of year	Cumulative number of policies lapsed at end of year 1, 2, 10, 20, and 30
BANKERS LIFE (IOWA)						
1	35	100,000	0.20	20,000	80,000	20,000
2	36	80,000	.09	7,200	72,800	27,200
10	44	53,541	.03	1,606	52,935	47,065
20	54	40,244	.03	1,207	39,037	60,963
30	64	29,677	.03	890	28,787	71,213
CENTRAL LIFE INSURANCE						
1	35	100,000	0.13	13,000	87,000	13,000
2	36	87,000	.05	4,350	82,650	17,350
10	44	69,007	.017	1,173	67,834	32,166
20	54	59,744	.011	687	59,057	40,943
30	64	53,868	.01	539	53,329	46,671
COMBINED INSURANCE CO. OF AMERICA (MONTHLY DEBIT ORDINARY)						
1	35	100,000	0.29	29,000	71,000	29,000
2	36	71,000	.08	5,680	65,320	34,680
10	44	48,574	.04	1,943	46,631	53,368
20	54	32,294	.04	1,292	31,002	68,998
30	64	21,470	.04	859	20,611	79,388
CONFEDERATION LIFE						
1	35	100,000	0.05	5,000	95,000	5,000
2	36	95,000	.15	14,250	80,750	19,250
10	44	57,905	.04	1,396	45,509	54,491
20	54	31,516	.04	1,261	30,255	69,745
30	64	20,953	.04	838	20,115	79,885

(continued on next page)

EXHIBIT 1 (continued)

TABULATION OF RESPONSES TO LIFE INSURANCE QUESTIONNAIRE NO. 1, QUESTION 33—Continued

AN ANALYSIS OF TERMINATIONS BY LAPSATION BASED ON A RADIX OF 100,000 STRAIGHT LIFE INSURANCE POLICIES ISSUED TO MALES AGE 35—Continued

Policy year	Attained age at beginning of year	Number of policies in force at beginning of year	Probability of withdrawal (lapse)	Number of policies lapsing in year	Number of policies in force at end of year	Cumulative number of policies lapsed at end of year 1, 2, 10, 20, and 30
CONNECTICUT GENERAL LIFE						
1	35	100,000	0.109	10,900	89,200	10,800
2	36	89,200	.085	7,582	81,618	91,382
10	44	63,723	.033	2,103	61,620	38,380
20	54	49,316	.027	1,331	47,985	52,115
30	64	37,509	.027	1,013	36,496	63,504
CONNECTICUT MUTUAL						
1	35	100,000	0.160	16,000	84,000	16,000
2	36	84,000	.06	5,040	78,960	21,040
10	44	63,591	.024	1,526	62,065	37,935
20	54	50,961	.018	917	50,044	49,956
30	64	43,018	.023	989	42,029	57,971
CROWN LIFE						
1	35	100,000	0.09	9,000	91,000	9,000
2	36	91,000	.054	4,914	86,086	13,919
10	44	67,967	.0225	1,529	66,438	33,562
20	54	55,903	.018	1,066	54,847	45,013
30	64	46,696	.018	841	45,855	54,145
EQUITABLE LIFE ASSURANCE SOCIETY						
1	35	100,000	0.185	18,500	81,500	18,500
2	36	81,500	.075	6,112	75,388	24,612
10	44	54,485	.03	1,634	52,851	47,149
20	54	40,596	.025	1,019	39,581	60,419
30	64	31,516	.025	788	30,728	69,272
FARMERS NEW WORLD						
1	35	100,000	0.29	29,000	71,000	29,000
2	36	71,000	.125	8,626	62,374	37,626
10	44	42,198	.033	1,392	40,806	59,194
20	54	30,960	.030	929	30,031	69,969
30	64	22,331	.030	685	22,146	77,854
FIDELITY UNION						
1	35	100,000	0.337	33,700	66,300	33,700
2	36	66,300	.24	15,912	50,388	49,612
10	44	34,767	.033	1,147	33,620	66,380
20	54	19,513	.028	546	24,967	75,033
30	64	NA	NA	NA	NA	NA
GENERAL AMERICAN LIFE						
1	35	100,000	0.170	17,000	83,000	17,000
2	36	78,350	.08	6,640	76,360	23,640
10	44	57,674	.030	1,730	55,944	44,056
20	54	45,096	.0205	924	44,172	55,828
30	64	36,229	.02	736	36,093	63,907
GENERAL UNITED						
1	35	100,000	0.20	20,000	80,000	21,000
2	36	80,000	.12	9,600	70,400	29,600
10	44	42,492	.042	2,040	40,452	59,548
20	54	27,666	.04	1,107	26,559	73,441
30	64	18,394	.04	736	17,658	82,342

See footnotes at end of table, p. 2891.

Policy year	Attained age at beginning of year	Number of policies in force at beginning of year	Probability of withdrawal (lapse)	Number of policies lapsing in year	Number of policies in force at end of year	Cumulative number of policies lapsed at end of year 1, 2, 10, 20, and 30
GEORGIA INTERNATIONAL						
1	35	100,000	0.182	18,200	81,800	18,200
2	36	81,800	.137	11,207	70,593	29,407
10	44	40,819	.051	2,082	38,737	61,263
20	54	26,108	.041	1,070	25,038	74,962
30	64	17,181	.041	704	16,477	83,523
HAMILTON NATIONAL						
1	35	100,000	0.22	22,000	78,000	22,000
2	36	78,000	.13	10,140	67,860	32,140
10	44	31,143	.05	1,957	37,186	62,814
20	54	24,796	.04	982	23,804	76,196
30	64	16,487	.04	659	15,828	84,172
HOME LIFE						
1	35	100,000	0.10	10,000	90,000	10,000
2	36	90,000	.06	5,400	84,600	15,400
10	44	65,031	.025	1,626	63,405	36,595
20	54	52,328	.02	1,046	51,282	48,718
30	64	42,757	.02	855	41,902	58,098
INTERSTATE LIFE & ACCIDENT						
1	35	100,000	0.298	29,800	70,200	29,800
2	36	70,200	.244	17,129	53,071	46,929
10	44	37,790	.026	972	36,418	63,582
20	54	29,028	.022	639	28,389	71,611
30	64	23,621	.02	472	23,149	76,851
JEFFERSON STANDARD						
1	35	100,000	0.15	15,000	85,000	15,000
2	36	85,000	.065	5,524	79,475	20,525
10	44	61,154	.026	1,590	59,564	40,436
20	54	48,458	.022	1,018	47,440	52,560
30	64	35,851	.04	1,428	34,513	65,487
JOHN HANCOCK						
1	35	100,000	0.278	27,800	72,200	27,800
2	36	72,200	.098	7,076	65,124	34,876
10	44	49,595	.031	1,537	48,058	51,942
20	54	37,834	.018	681	37,153	62,847
30	64	31,837	.025	798	31,139	68,861
LAFAYETTE						
1	35	100,000	0.20	20,000	80,000	20,000
2	36	80,000	.08	6,400	73,600	26,400
10	44	57,035	.03	1,711	55,324	44,676
20	54	44,128	.02	922	45,206	54,794
30	64	41,297	.01	413	40,884	59,116
LAMAR						
1	35	100,000	0.214	21,400	78,600	21,400
2	36	78,600	.035	2,751	75,849	24,151
10	44	63,228	.017	1,076	62,252	37,748
20	54	54,844	.0115	631	54,213	45,787
30	64	48,251	.012	591	48,660	51,340

(continued on next page)

EXHIBIT 1 (continued)

TABULATION OF RESPONSES TO LIFE INSURANCE QUESTIONNAIRE NO. I, QUESTION 33—Continued

AN ANALYSIS OF TERMINATIONS BY LAPSATION BASED ON A RADIX OF 100,000 STRAIGHT LIFE INSURANCE POLICIES ISSUED TO MALES AGE 35—Continued

Policy year	Attained age at beginning of year	Number of policies in force at beginning of year	Probability of withdrawal (lapse)	Number of policies lapsing in year	Number of policies in force at end of year	Cumulative number of policies lapsed at end of year 1, 2, 10, 20, and 30
LIBERTY LIFE						
1	35	100,000	0.23	23,000	77,000	23,000
2	36	77,000	.099	7,623	69,377	30,623
10	44	47,426	.039	1,850	45,574	54,426
20	54	34,934	.022	978	33,956	66,044
30	64	25,298	.028	736	25,562	74,438
LIBERTY NATIONAL						
1	35	100,000	0.275	27,500	72,500	27,500
2	36	72,500	.15	10,875	61,625	38,375
10	44	42,483	.03	1,274	41,209	58,791
20	54	31,329	.03	940	30,389	69,611
30	64	23,103	.03	693	22,410	77,590
LINCOLN NATIONAL						
1	35	100,000	0.18	18,000	82,000	18,000
2	36	82,000	.075	6,150	75,850	24,150
10	44	56,519	.037	2,091	54,428	45,572
20	54	41,769	.029	1,211	40,558	59,442
30	64	31,122	.029	902	30,220	69,780
MASSACHUSETTS MUTUAL						
1	35	100,000	0.056	5,600	94,400	5,600
2	36	94,400	.035	3,304	91,096	8,904
10	44	71,641	.023	1,648	69,993	30,007
20	54	57,293	.022	1,260	56,033	43,967
30	64	45,870	.022	1,009	44,861	55,139
METROPOLITAN						
1	35	100,000	0.188	18,800	81,200	18,800
2	36	81,200	.0855	6,943	74,257	25,743
10	44	53,397	.028	1,495	51,902	48,098
20	54	42,485	.02	850	41,635	58,365
30	64	34,712	.02	694	34,018	65,982
MINNESOTA MUTUAL						
1	35	100,000	0.115	11,500	88,500	11,500
2	36	88,500	.06	5,310	83,190	16,810
10	44	57,484	.05	2,874	54,610	45,390
20	54	39,619	.03	1,188	38,431	61,569
30	64	29,156	.031	904	28,252	71,748
MONUMENTAL						
1	35	[2] 100,000	0.288	28,800	71,200	28,800
2	36	71,200	.107	7,618	63,582	36,418
10	44	41,915	.024	1,006	40,909	59,091
20	54	31,859	.023	733	31,126	68,874
30	64	25,090	.021	527	24,563	75,437
MONUMENTAL						
1	35	[3] 100,000	0.314	31,400	68,600	31,400
2	36	68,600	.163	11,182	57,419	42,582
10	44	43,326	.018	780	42,546	57,454
20	54	36,721	.013	477	36,244	63,756
30	64	32,841	.0225	739	32,102	67,898

Policy year	Attained age at beginning of year	Number of policies in force at beginning of year	Probability of withdrawal (lapse)	Number of policies lapsing in year	Number of policies in force at end of year	Cumulative number of policies lapsed at end of year 1, 2, 10, 20, and 30
MUTUAL BENEFIT OF NEW JERSEY						
1	35	100,000	0.066	6,600	93,400	6,600
2	36	93,400	.064	5,978	87,422	12,578
10	44	59,514	.04	2,380	57,134	42,866
20	54	43,631	.0185	807	42,824	57,176
30	64	34,515	.035	1,208	33,307	66,693
MUTUAL LIFE OF NEW YORK						
1	35	100,000	0.18	18,000	82,000	18,000
2	36	82,000	.078	6,396	75,604	24,396
10	44	53,561	.033	1,767	51,794	48,206
20	54	40,693	.025	1,017	39,676	60,324
30	64	31,592	.025	790	30,802	69,198
NATIONAL INVESTORS						
1	35	100,000	0.20	20,000	80,000	20,000
2	36	80,000	.12	9,600	70,400	29,600
10	44	41,150	.050	2,057	39,093	60,907
20	54	26,512	.040	1,060	25,452	74,548
30	64	17,627	.040	705	16,922	83,078
NATIONAL LIFE & ACCIDENT						
1	35	100,000	0.263	26,300	73,700	26,300
2	36	73,700	.117	8,623	65,077	34,923
10	44	42,711	.036	1,537	41,174	58,826
20	54	32,185	.027	869	31,316	68,884
30	64	24,478	.027	661	23,817	76,183
NATIONAL LIFE OF VERMONT						
1	35	100,000	0.10	10,000	90,000	10,000
2	36	90,000	.045	4,050	85,950	14,050
10	44	69,441	.025	1,736	67,705	32,295
20	54	53,909	.025	1,348	52,561	47,439
30	64	41,850	.025	1,046	40,804	59,196
NATIONAL OLD LINE						
1	35	100,000	0.20	20,000	80,000	20,000
2	36	80,000	.10	8,000	72,000	28,000
10	44	55,343	.025	1,383	53,960	46,040
20	54	44,532	.02	891	43,641	56,359
30	64	36,387	.02	728	35,659	64,341
NATIONWIDE						
1	35	100,000	0.25	25,000	75,000	25,000
2	36	75,000	.105	7,875	67,125	32,875
10	44	49,367	.03	1,481	47,886	52,114
20	54	38,128	.025	953	37,175	62,825
30	64	31,046	.02	621	30,425	69,575
NEW ENGLAND MUTAL						
1	35	100,000	0.098	9,800	90,200	9,800
2	36	90,200	.068	6,134	84,066	15,934
10	44	62,102	.027	1,677	60,425	39,575
20	54	50,279	.02	1,005	49,274	50,726
30	64	40,665	.03	1,220	39,445	60,555

See footnotes at end of table, p. 2891.

(continued on next page)

EXHIBIT 1 (continued)

TABULATION OF RESPONSES TO LIFE INSURANCE QUESTIONNAIRE NO. 1, QUESTION 33—Continued

AN ANALYSIS OF TERMINATIONS BY LAPSATION BASED ON A RADIX OF 100,000 STRAIGHT LIFE INSURANCE POLICIES ISSUED TO MALES AGE 35—Continued

Policy year	Attained age at beginning of year	Number of policies in force at beginning of year	Probability of withdrawal (lapse)	Number policies lapsing in year	Number of policies in force at end of end of year	Cumulative number of policies lapsed at end of year 1, 2, 10, 20, and 30
NEW YORK LIFE						
1	35	100,000	0.19	19,000	81,000	19,000
2	36	81,000	.05	4,050	76,950	23,050
10	44	56,982	.034	1,937	55,045	44,955
20	54	43,784	.019	832	42,952	57,048
30	64	31,826	.018	573	31,253	68,747
NORTHWESTERN MUTUAL						
1	35	100,000	0.062	6,200	93,800	6,200
2	36	93,800	.019	1,782	92,018	7,982
10	44	80,948	.018	1,457	79,491	20,509
20	54	67,502	.018	1,215	66,287	33,713
30	64	56,288	.018	1,013	55,275	44,725
NORTHWESTERN NATIONAL						
1	35	100,000	0.20	20,000	80,000	20,000
2	36	80,000	.08	6,400	73,600	26,400
10	44	53,993	.025	1,347	52,646	47,454
20	54	43,355	.02	867	42,498	57,502
30	64	35,433	.02	709	34,724	65,276
OCCIDENTAL (CALIFORNIA)						
1	35	100,000	0.18	18,000	82,000	18,000
2	36	82,000	.07	5,740	76,260	23,740
10	44	64,859	.02	1,297	63,562	36,438
20	54	52,996	.02	1,060	51,936	48,064
30	64	43,301	.02	866	42,435	57,565
OHIO STATE LIFE						
1	35	100,000	0.286	28,600	71,400	28,600
2	36	71,400	.119	8,497	62,903	37,097
10	44	39,203	.04	1,568	37,635	62,365
20	54	26,064	.04	1,042	25,022	74,978
30	64	17,330	.04	693	16,637	83,363
PACIFIC MUTUAL						
1	35	100,000	0.217	21,700	78,300	21,700
2	36	78,300	.06	4,698	73,602	26,398
10	44	60,056	.02	1,201	58,855	41,145
20	54	49,071	.02	981	48,090	51,910
30	64	40,078	.02	801	39,277	60,723
PENN MUTUAL						
1	35	100,000	0.217	21,700	78,300	21,700
2	36	87,500	.100	8,750	78,750	30,450
10	44	62,193	.030	1,866	60,327	39,673
20	54	45,862	.030	1,376	44,486	55,514
30	64	33,820	.030	1,015	32,805	67,195
PHOENIX MUTUAL						
1	35	100,000	0.147	14,700	85,300	14,700
2	36	85,300	.08	6,824	78,476	21,524
10	44	58,470	.036	2,033	54,437	45,563
20	54	41,596	.025	1,040	40,556	59,444
30	64	29,974	.043	1,289	28,685	71,315

Policy year	Attained age at beginning of year	Number of policies in force at beginning of year	Probability of withdrawal (lapse)	Number policies lapsing in year	Number of policies in force at end of end of year	Cumulative number of policies lapsed at end of year 1, 2, 10, 20, and 30
PILOT LIFE						
1	35	100,000	0.15	15,000	85,000	15,000
2	36	85,000	.075	6,525	79,475	20,525
10	44	59,876	.026	1,557	58,319	41,681
20	54	47,445	.021	996	46,449	53,551
30	64	35,272	.040	1,411	33,861	66,139
PROVIDENT LIFE & ACCIDENT						
1	35	100,000	0.092	9,200	90,800	9,200
2	36	90,800	.087	7,900	82,900	17,100
10	44	58,170	.036	2,094	56,076	43,924
20	54	42,236	.026	1,048	41,138	58,862
30	64	33,779	.0205	692	33,087	66,913
PROVIDENT MUTUAL LIFE OF PHILADELPHIA						
1	35	100,000	0.126	12,600	87,400	12,600
2	36	87,400	.053	4,632	82,768	17,232
10	44	64,828	.03	1,945	62,883	37,117
20	54	52,427	.02	1,049	51,378	48,622
30	64	42,836	.02	857	41,979	58,021
PRUDENTIAL						
1	35	100,000	0.102	10,200	89,800	10,200
2	36	89,800	.099	8,890	80,910	19,090
10	44	57,666	.0235	1,355	56,311	43,689
20	54	49,573	.008	396	49,177	50,823
30	64	45,312	.011	498	44,814	55,186
REPUBLIC NATIONAL						
1	35	100,000	0.15	15,000	85,000	15,000
2	36	85,000	.10	8,500	76,500	23,500
10	44	43,108	.064	2,328	40,780	59,220
20	54	28,265	.030	848	27,417	72,583
30	64	22,077	.015	331	21,746	78,254
SOUTHLAND						
1	35	100,000	0.2042	20,420	79,580	20,420
2	36	79,580	.1045	8,316	71,264	28,736
10	44	54,678	.0223	1,786	52,910	47,090
20	54	40,424	.0285	1,152	39,272	60,728
30	64	30,275	.0285	863	29,412	70,588
SOUTHWESTERN LIFE						
1	35	100,000	0.10	10,000	90,000	10,000
2	36	90,000	.05	4,500	85,500	14,500
10	44	71,979	.02	1,440	70,539	29,461
20	54	58,812	.02	1,176	57,636	42,364
30	64	48,054	.02	961	47,093	52,907
STATE FARM						
1	35	100,000	0.181	18,100	81,900	18,100
2	36	81,900	.116	9,500	72,400	27,600
10	44	58,412	.02	1,168	57,244	42,756
20	54	49,459	.015	742	48,717	51,283
30	64	42,037	.015	630	41,407	58,593

See footnotes at end of table, p. 2891.

(continued on next page)

EXHIBIT 1 (continued)

TABULATION OF RESPONSES TO LIFE INSURANCE QUESTIONNAIRE NO. 1, QUESTION 33—Continued

AN ANALYSIS OF TERMINATIONS BY LAPSATION BASED ON A RADIX OF 100,000 STRAIGHT LIFE INSURANCE POLICIES ISSUED TO MALES AGE 35—Continued

Policy year	Attained age at beginning of year	Number of policies in force at beginning of year	Probability of withdrawal (lapse)	Number policies lapsing in year	Number of policies in force at end of year	Cumulative number of policies lapsed at end of year 1, 2, 10, 20, and 30
STATE LIFE						
1	35	100,000	0.203	20,300	79,700	20,300
2	36	79,700	.092	7,332	72,368	27,632
10	44	51,940	.03	1,558	50,382	49,618
20	54	38,304	.03	1,149	37,155	62,845
30	64	28,246	.03	847	27,399	72,601
STATE MUTUAL LIFE ASSURANCE (REGULAR STRAIGHT LIFE BUSINESS)						
1	35	100,000	0.096	9,600	91,400	9,600
2	36	91,400	.074	6,764	84,636	15,364
10	44	60,677	.031	1,881	58,796	41,204
20	54	46,368	.021	974	45,394	54,606
30	64	37,502	.021	787	36,715	63,285
STATE MUTUAL LIFE ASSURANCE (NON-CIGARETTE SMOKER STRAIGHT LIFE POLICY)						
1	35	100,000	0.060	6,000	94,000	6,000
2	36	94,000	.052	4,888	89,112	10,888
10	44	70,735	.022	1,556	69,179	30,821
20	54	58,626	.015	879	57,747	42,253
30	64	50,405	.015	756	49,649	50,351
TRAVELERS						
1	35	100,000	0.189	18,900	81,100	18,900
2	36	81,100	.085	6,893	74,207	25,793
10	44	53,977	.035	1,889	52,088	47,912
20	54	40,818	.024	980	39,838	60,162
30	64	30,254	.035	1,059	29,195	70,805
UNION CENTRAL						
1	35	100,000	0.250	25,000	75,000	25,000
2	36	75,000	.07	5,250	69,750	30,250
10	44	53,787	.03	1,614	52,173	47,827
20	54	39,663	.03	1,170	38,493	61,507
30	64	29,262	.03	878	28,386	71,614
UNITED BENEFIT						
1	35	100,000	0.215	21,500	78,500	21,500
2	36	78,500	.14	10,990	67,510	32,490
10	44	42,815	.04	1,713	41,102	58,898
20	54	31,723	.025	793	30,930	69,070
30	64	24,628	.025	616	24,012	75,988
WESTERN & SOUTHERN						
1	35	[4] 100,000	0.167	16,700	83,300	16,700
2	36	83,300	.126	10,496	72,804	27,196
10	44	49,507	.029	1,436	48,071	51,929
20	54	40,049	.018	721	39,328	60,672
30	64	33,398	.018	601	32,797	67,203

[1] Nonpar policies only.
[2] Premium notice business only.
[3] Monthly debit ordinary business only.
[4] Ordinary business only: "executive-preferred" excluded.
[5] Premium notice debit business.

EXHIBIT 2

	Ordinary Life (Level death benefits and premiums payable to age 100)	Ten Year Term (Convertible, nonrenewable, level death benefits and premiums for 10 years)
Issue Age	30	30
Sex	Male	Male
Annual per $1,000 premium	$18.00	$ 5.00
Annual policy fee	$15.00	$15.00
Reserve basis	1958 CSO age last birthday 3% continuous functions Commissioners Reserve Valuation Method	1958 CSO age last birthday 3% continuous functions Commissioners Reserve Valuation Method
Cash values	Reserve rounded to nearest dollar	None

EXHIBIT 3

	Ordinary Life	Ten Year Term
Interest rate	6%	6%
Mortality	1965-70 Basic Life Tables Age last birthday Select and ultimate	1965-70 Basic Life Tables Age last birthday Select and ultimate
Average size	$25,000	$25,000
Commissions and related agency compensation (as % of premium):		
Policy Year 1	90.0%	60.0%
Policy Year 2-10	7.5	7.5
Thereafter	3.0	---
Expenses		
Policy Year 1	20% of premium $30.00/policy $ 2.00/$1,000	20% of premium $30.00/policy $ 2.00/$1,000
Thereafter (per year)	2.5% of premium $ 5.00/policy	2.5% of premium $ 5.00/policy
Cost of processing death claim	$45	$45
Cost of processing lapse	$12	$12
Conversion rate = % of policies entering year x which don't enter year x + 1 because they change to a new plan, and cost of conversion = cost per $1,000 converted		

(continued on next page)

EXHIBIT 3 (continued)

	Ordinary Life	Ten Year Term	
Policy Year		Conversion Rate	Cost of Conversion
1	None	2%	$ .10
2	None	6	.40
3	None	7	.50
4	None	7	.55
5	None	7	.60
6	None	7	.65
7	None	7	.70
8	None	7	.75
9	None	10	1.20
10	None	14	1.50

EXHIBIT 4

Of 1,000 Policies Issued, the Number in Effect at the End Of each Policy Year, Based on Stated Mortality, Lapse and, In the Case of Ten Year Term, Conversion Rates

Policy Year	Lapse Experience		
	Low(=None)	Medium	High
	Ordinary Life		
1	999	854	708
2	998	800	620
3	997	759	557
4	996	725	507
5	995	694	465
6	994	669	432
7	992	646	403
8	990	627	379
9	988	609	359
10	986	594	342
11	983	579	326
12	980	566	312
13	977	554	300
14	974	542	288
15	970	530	277
16	966	520	267
17	962	509	257
18	957	499	248
19	952	488	239
20	947	478	230
25	910	424	188
30	851	363	147
35	766	286	101
40	648	213	66
	Ten Year Term		
1	979	812	645
2	920	667	453
3	854	562	343
4	794	476	263
5	737	405	203
6	684	352	164
7	635	308	135
8	590	272	113
9	530	233	93
10	454	192	73

EXHIBIT 5

Annual Dividends

Policy Year	Lapse Experience: Low(=None)	Medium	High
		Ordinary Life	
1	$ --	$ --	$ --
2	1.25	.75	.25
3	1.50	1.00	.50
4	1.98	1.50	.95
5	2.63	2.18	1.56
6	3.41	3.00	2.30
7	4.26	3.90	3.14
8	5.15	4.84	4.06
9	6.05	5.78	5.03
10	6.92	6.70	6.01
11	7.74	7.57	6.98
12	8.50	8.38	7.91
13	9.19	9.10	8.79
14	9.80	9.74	9.58
15	10.32	10.30	10.25
16	10.78	10.79	10.80
17	11.17	11.21	11.19
18	11.77	11.76	11.80
19	12.31	12.33	12.32
20	12.81	12.79	12.82
25	15.92	15.94	15.96
30	18.89	18.92	18.97
35	22.30	22.37	22.48
		Ten Year Term	
1	$ --	$ --	$ --
2	.50	.25	.10
3	.96	.65	.13
4	1.42	1.05	.16
5	1.88	1.45	.19
6	2.34	1.85	.22
7	2.80	2.25	.25
8	3.26	2.65	.28
9	3.72	3.05	.31
10	4.18	3.45	.34

EXHIBIT 6

Of practical necessity, the disclosure formula must be simple, giving a broad overview of persistency. However, this simplicity can also mask underlying reasons for variations in lapse rates. If a company wants to examine in greater depth specific factors affecting its persistency, the disclosure method can be expanded to take account of these items appropriately. In essence, selected characteristics would be isolated and subjected to a normalization procedure (i.e., by using consistent inforces) to see if the company's persistency, absent unwanted influences, falls within acceptable ranges. This would be the "washing out" procedure referred to in the chapter.

An example of how this can be accomplished is shown on the next page. Mode of premium payment will be the variant under deeper review, but the method is equally applicable to other characteristics, individually or in combination. It should be clearly understood that the more factors simultaneously taken into account, the more complex will be the calculation. Also, industry standard lapse rates would have to be available for items under review.

Suppose a company's actual to expected lapse ratio, per the disclosure formula, is 1.20 for policy year 1, an amount that the company may consider to be on the high side. The company issues only four premium modes, namely, annual, semiannual, quarterly and monthly. The company feels that its modal distribution is different from the industry's, causing its higher than normal actual to expected ratio. The company plans to study the modal effects on first year lapse rates and sets up a table as follows:

TABLE 28

Type of Product, Duration 1

Mode	(1) Industry Standard Lapse Rates	(2) Inforce	(3) Actual Lapses	(4) Expected Lapses = (1) x (2)	(5) Actual to Expected Lapse Ratio = (3) ÷ (4)
		Basic Disclosure Formula			
All Combined	.17	1,000	204	170	1.20 (=a non-normalized ratio as to premium mode)

(continued on next page)

TABLE 28 (continued)

Basic Disclosure Formula Expanded to Reflect Modal Variations

Annual	.12	300	30	36	.83
Semiannual	.16	100	14	16	.88
Quarterly	.22	200	40	44	.91
Monthly	.26	400	120	104	1.15
All Combined	xxx	1,000	204	200	1.02 (=a normalized ratio as to premium mode)

(Note: Inforce distributions shown above are on an absolute basis. For convenience of calculation, either a percentage or an absolute amount can, in fact, be used.)

Normalization by mode is completed by applying the industry standard lapse rates to the company's inforces by mode to determine expected lapses for each mode. The figures in the example indicate that for the annual, semiannual and quarterly modes, the company's actual lapses are better than expected, but not so for monthly. The figures by mode in columns (3) and (4) are summed to obtain the aggregate expected lapses normalized for mode. The normalized actual to expected lapse ratio then becomes 1.02 (204 ÷ 200), suggesting that the company's first year lapse rate is quite normal. The reason for the actual to expected ratio of 1.20 on the non-normalized basis is the disparity in distribution of inforce by mode between the company and the industry, and this is not recognized in the simplified disclosure calculation.

Actually, the components of the calculation show that the company is not "quite normal." Its poorer than average experience on monthly business is balanced by superior performance on the other modes. The place to start to improve persistency in duration 1 is with the monthly mode.

This example illustrates that the disclosure formula reflects industry composite distributions of business in force in arriving at standard lapse rates. Companies with proportions of business in force markedly different from the industry composite can produce actual lapses which vary from the norm -- often quite justifiably -- as a result of their particular mix of business.

(C) Committee Technical Task Force
To Review Valuation and Nonforfeiture Value Regulation

Life Insurance

December 1978

CONTENTS

December 1978 Report

This report concerns only the proceedings of the NAIC Technical Task Force to Review Valuation and Nonforfeiture Value Regulation since the June 1978 meeting. There are no recommendations with this report.

A. Proceedings of the NAIC Technical Task Force

Attached to this report are draft copies of the minutes for the meetings for June 10-11, 1978 (Attachment A), and October 25-26, 1978 (Attachment B). The attachments to the minutes for the June 10-11, 1978 meeting include only the attachments identified therein as A-1 through A-4. The attachments identified as A-5 through A-10 have been deleted as they do not pertain to life insurance.

Also attached are a revised table of mortality rates forming a part of Actuarial Guideline C previously recommended by the NAIC Technical Task Force entitled "Actuarial Interpretation Regarding Minimum Reserves for Certain Forms of Term Life Insurance" (Attachment C, appears in 1978 Proc, V. II pp. 416-418); a letter from John Montgomery of the Technical Task Force dated October 18, 1978 (Attachment D, not reproduced here); a letter from John Booth dated November 8, 1978, pertaining to guidelines for deposit-term-type products and to the minutes of the December 4, 1977 meeting of the NAIC Technical Task Force (Attachment E); Alfred N. Guertin's recent paper entitled "Forms of Policies Providing for a Supplementary First Year Premium Not Dependent on Age (Attachment F-1); letters from Burnett A. Halstead and George W. Harding relating to deposit term insurance (Attachments F-2 and F-3 respectively); a letter from E. James Morton dated October 13, 1978, concerning a proposed change in the Standard Nonforfeiture Law (Attachment F-4). Other attachments are a memorandum from John Montgomery dated September 15, 1978, relating to interpretations by the California Department (Attachment G); a paper from the Variable Products Technical Advisory Committee dated October 25, 1978 (Attachment H); and a letter from James R. Carlisle of the Alabama Department dated August 21, 1978, relating to insurance companies which are earning interest at a lower rate than the rate assumed in their reserves (Attachment I).

Items 1 through 7 below relate to topics which have been listed on the agenda of the NAIC Technical Task Force.

1. Actuarial Guidelines

a. Four Previous Guidelines The Special Report of the NAIC Technical Task Force dated May 8, 1978, recommended four guidelines to the (C3) Life Insurance Subcommittee. As requested in the Special Report, these four guidelines were adopted with a recommendation to the (A5) Financial Condition Examination Subcommittee that such guidelines be included in the Financial Condition Examiners Handbook. The (A5) Financial Condition Examination Subcommittee has been notified, and that subcommittee expects to consider the inclusion of the guidelines in the Handbook at its December 1978 meeting.

One of the four guidelines, Guideline A, "Reserve Requirements with Respect to Interest Rates Guarantees on Active Life Funds Held Relative to Group Annuities," requires that the NAIC Technical Task Force supply the NAIC Central Office with a valuation interest assumption to be applied in the valuation of group annuity contributions received in the most recent calendar year. This interest assumption is identified as "i_{my}" in the text of the guideline, which appears in Attachment A of the Special Report of May 8, 1978. The NAIC Technical Task Force has determined that .081 is the value of "i_{my}" for contributions received in 1978.

James L. Sweeney of Munich American Reassurance Company has pointed out a relatively minor error in the table which forms part of another of these guidelines, Guideline C, "Actuarial Interpretation Regarding Minimum Reserves for Certain Forms of Term Life Insurance." The correction applies to Attachment C of the Special Report of May 8, 1978. The correct mortality rate for males, age 85, on the age last birthday basis is 0.1664679 rather than 0.1665769. This was a typographical error, affecting only one figure in these tables. Attachment C is a complete table of mortality rates, which includes this one necessary revision (the revision appears in the version published in 1978 Proc. V. II pp. 416-418).

A question has arisen with respect to the minutes of the NAIC Technical Task Force meeting of December 4, 1977, as they relate to this same guideline. At least one early discussion draft for this guideline contained a five year grade-in period, during which insurance companies which had not previously been setting up the reserves required by its terms could build up to the full level of these reserves. This grade-in provision was deleted from the guideline in the final version approved by the NAIC Technical Task Force at its meeting of April 6-7, 1978. The question is whether the minutes of the December 4, 1977, meeting intended to refer to a draft version of this guideline with or without the grade-in provision, when they stated that the grade-in provision should be left unchanged. Further information on this subject is included in Attachment E. The NAIC Technical Task Force plans to discuss this subject further at its December 1978 meeting, and it will consider amending the minutes for its December 4, 1977 meeting.

b. Deposit Term Life Insurance The NAIC Technical Task Force has continued to work on this guideline, and some progress seems to have been made in the area of disclosure requirements. The question of whether or not the guideline should define a special higher scale of minimum nonforfeiture values at each policy year for deposit term type policies has not been resolved by the NAIC Technical Task Force. Even if such a special scale of minimum values were determined to be desirable, there is some concern that it could not be implemented under the present wording of the Standard Nonforfeiture Law.

Attachment E contains a revised draft proposal which separates the subjects of disclosure and minimum nonforfeiture values into two distinct guidelines. The proposed disclosure guidelines in Attachment E now incorporate a number of changes suggested by members of the NAIC Technical Task Force at its previous meetings. The proposed minimum nonforfeiture guidelines in Attachment E do define a special higher scale of minimum nonforfeiture values at each policy year, as described above. The titled to both proposed guidelines inn Attachment E now refer to "partial-endowment-type" policies rather than "deposit-term-type" policies.

This topic has attracted a great deal of interest, and the NAIC Technical Task Force has been supplied with reference materials for its consideration. Some of these are included as Attachments F-1, F-2 and F-3.

The NAIC Technical Task Force will consider this topic further at its December 1978 meeting. Two related topics will also be considered, a proposed amendment to the Standard Nonforfeiture Law which would apply to life insurance policies with premiums that decrease during the first ten years (Attachment F-4) and the relationship of successive cash values in life insurance policies.

c. Other Guidelines The NAIC Technical Task Force is also reviewing a collection of interpretations which the California Department has made in applying the California Insurance Code (Attachment G) to determine if some or all of them are suitable for guidelines. This is a second draft, and some revisions have been made so that these interpretations will better conform with other actions taken by the NAIC Technical Task Force.

The NAIC Technical Task Force also needs to develop a guideline to assist state insurance departments in distinguishing annuities from life insurance contracts. This is especially important for those states which have passed the new NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities, since the same contract will typically require higher minimum nonforfeiture values if it is considered an annuity rather than a life insurance policy.

Both of these subjects are on the agenda forthe December 1978 meeting of the NAIC Technical Task Force.

2. Construction of a New Mortality Table

The NAIC Technical Task Force has postponed action on this topic, since the Society of Actuaries has a Special Committee to Recommend New Mortality Tables for Valuation which is developing new tables. Gary See, a member of this Special Committee, reported orally to the NAIC Technical Task Force at its meeting of October 25-26, 1978. It appears that the Special Committee has now reached agreement on the basic mortality rates, and also on the margins which it

considers proper for the loaded table. However, no written report was available at that time; and the final report of the Special Committee to the Society of Actuaries is not expected until after the December 1978 meeting of the NAIC Technical Task Force. This final report of the Special Committee is expected in January or February 1979; but it should be noted that this report will need to be reviewed and acted upon by the Board of Governors of the Society of Actuaries after they receive it.

The NAIC Technical Task Force can only make limited progress on this topic at its December 1978 meeting. It expects to discuss the manner in which the new tables can be tested when the mortality rates are available.

3. Revision of Standard Nonforfeiture Law

This topic is very closely related to the topic described above, "Construction of a New Mortality Table." It is necessary to know the level of mortality rates, before the appropriate expense allowances used in determining minimum nonforfeiture values can be defined. Also the new tables are intended for the calculation of reserves, and some modification may be needed before they are suitable for determining minimum nonforfeiture values.

Therefore the NAIC Technical Task Force cannot undertake a recommendation for comprehensive revision of the Standard Nonforfeiture Law at this time. At its December 1978 meeting, the NAIC Technical Task Force does expect to discuss the form of expense allowance to be used in testing the new mortality tables now being developed by the Society of Actuaries Special Committee.

Attachment F-4 represents a suggestion which the NAIC Technical Task Force has received for modification of one portion of the Standard Nonforfeiture Law. This modification would affect only those life insurance policies written under a plan where the gross premium decreases during the first ten years, and typically it would require higher minimum cash values in most policy years than those which are now required under the Standard Nonforfeiture Law. It should be noted that this modification would apply to most deposit-term-type products, as described in item 1b above, but it would not be limited to such plans. The NAIC Technical Task Force expects to discuss this proposal at its December 1978 meeting.

4. Relationship of Successive Cash Values in Life Insurance Policies

Certain life insurance policies which are now being sold have been criticized because of the relationship between successive cash surrender values. That is, in at least one case, the increase in the cash value at the end of a policy year over the cash value at the end of the previous policy year does not appear to bear any reasonable relation to the gross premium due from the policyholder and the benefits provided by the insurance company during that policy year.

The question has been raised whether or not such policies should be disapproved as unfair or inequitable, even if each cash surrender value examined individually is equal to or greater than the minimum cash surrender value defined by the Standard Nonforfeiture Law. It should be noted that some of the policies which have been criticized are deposit-term-type products as described in item 1b above. However, this criticism can certainly not be applied to all deposit-term-type products which are currently being sold, and the same criticism can apply to life insurance policies written on other plans.

The NAIC Technical Task Force expects to discuss this topic at its December 1978 meeting. The topic has not previously appeared in the NAIC Technical Task Force agenda, and there has been only very limited discussion and consideration of the subject.

5. Variable Annuity Nonforfeiture Regulation

The NAIC Technical Task Force had previously received a report from the Variable Products Technical Advisory Committee which contained suggested changes in the NAIC Model Variable Annuity Regulation relating to minimum nonforfeiture values. (Please see Attachment H of the June 1978 Report of the NAIC Technical Task Force to the (C3) Life Insurance Subcommittee.) However, the NAIC Technical Task Force asked that the Variable Products Technical Advisory Committee give further consideration to certain questions raised by Harold Leff of Metropolitan Life Insurance Company, such as whether the proposed schedule of minimum nonforfeiture values made adequate provision for future inflation in the expense allowance.

Attachment H is a paper prepared by the Variable Products Technical Advisory Committee on October 25, 1978, after meeting with Mr. Leff and reviewing these questions. The NAIC Technical Task Force received this paper at its October 25-26, 1978 meeting; but it decided not to take any immediate action. The NAIC Technical Task Force has asked the Variable Products Technical Committee to supply certain additional information relating to the questions raised by Mr. Leff. This information is described in detail in Attachment B, in the section near the end entitled "Variable Annuity Nonforfeiture Regulation."

Jerome S. Golden, Chairman of the Variable Products Technical Committee, has advised that it has been impossible to hold a meeting of his committee before the NAIC Technical Task Force meets in December 1978. Thus, the Technical Task Force does not expect to make any further progress on this topic at its December 1978 meeting.

6. Problem Plans

No such plans have been submitted to the NAIC Technical Task Force during the period covered by this report.

7. Companies Earning Lower Interest Rates Than the Rate Assumed in Their Reserves

This is a joint topic which involves credit insurance and accident and health insurance in addition to life insurance.

The NAIC Technical Task Force began work on this topic in response to a letter from James R. Carlisle of the Alabama Department dated August 21, 1978 (Attachment I). The letter suggests that such insurance companies be required to set up a special additional reserve, and includes a formula which might be used for that purpose. Attachment D includes John Montgomery's comments on this topic, and on the formula which was presented. The NAIC Technical Task Force discussed this topic at its October 25-26, 1978 meeting, but did not reach any conclusions. This topic will be considered further at the December 1978 meeting.

Attachment D points out that this topic is interrelated to some extent with the work of the (A3) Subcommittee Task Force on Life and Health Insurance Early Warning System Tests. Also the solution to the underlying problem may involve revision of Page 6, "Analysis of Increase in Reserves during the Year" and possible revision of other parts of the annual statement blank.

B. Recommendations

There are no recommendations attached to this report.

Ted Becker, Chairman, Texas; John O. Montgomery, California; Thomas J. Kelly, New York; Larry Gorski, Illinois; Erma Edwards, Nevada; Bradford S. Gile, Wisconsin; Thomas A. Bickerstaff, Pennsylvania; James Montgomery III, District of Columbia.

ATTACHMENT A

(C) Committee Technical Task Force To
Review Valuation and Nonforfeiture Value Regulation

Life Insurance

Washington, D.C.
June 10 and 11, 1978

The NAIC (C) Committee Technical Task Force To Review Valuation and Nonforfeiture Value Regulation met from 9:30 a.m. until 1:00 p.m. on June 10, 1978 in the Military Room of the Washington Hilton Hotel, Washington, D.C. to consider matters pertaining to the (C3) Life Insurance Subcommittee. The task force met again from 9 a.m. to 6 p.m. on June 11, 1978, in the Lincoln West Room at the same hotel to consider matters pertaining to the (C1) Accident and Health Insurance Subcommittee, and to the (C2) Credit Insruance Subcommittee. The following task force members were present:

John O. Montgomery, Chairman, California; Ted Becker, Texas; Robert J. Dolan, Pennsylvania; Erma Edwards, Nevada; Larry Groski, Illinois (June 11 only); Thomas J. Kelly, New York; James R. Montgomery, III, District of Columbia (June 10 only); Marvin Van Cleave, Wisconsin (June 11 only, representing Bradford S. Gile).

The following persons were present for the June 10, 1978, meeting: J. Stephen Beckman, United Investors Life; John K. Booth, American Council of Life Insurance; Doug Broome, South Carolina Insurance Department; Greg Carney, Anchor National Life; Grace V. Dillingham, American Council of Life Insurance; Ann Enarson, Kemper Life Companies; Charles Greeley, Metropolitan Life; George Harding, University Life; David Holland, Munich American Reassurance; H. C. Jaros, United Investors Life; Howard Kayton, Security First Group; Harold Leff, Metropolitan Life; Richard V. Minck, American Council of Life Insurance; John J. Nietmann, Jr., American Council of Life Insurance; William A. White.

The following persons were present for part or all of the June 11, 1978 meeting: Jim Berens, Centurion Life Insurance Company; James F. Blazek, Alexander Hamilton Life and Maryland Life; Doug Broome, South Carolina Insurance Department; Rod Bucher, Old Republic Life; Vincent W. Donnelly, American Council of Life Insurance; Harvey Galloway, Jr., Nationwide Corporation; James H. Hunt, Massachusetts Insurance Department; Ken Jones, Cuna Mutual Insurance Group; Michael Kazakoff, Mutual of Omaha; Spencer Koppel, Combined Insurance Companies; Michael F. Medland, Cuna Mutual Insurance Group; Norris Robinson, Merit Life Insurance Company; Robert Sable, National Consumer Law Center; James Stump, American Council of Life Insurance; Peter Thexton, Health Insurance Association of America; Brooks G. Trueblook, Credit Life Insurance Company; Bob Tyler, Old Republic Life; Charles M. Underwood, II, Alexander Hamilton Life; Ronald M. Wolf, Tillinghast, Nelson and Warren, Inc.

Minutes of the Task Force

Chairman Montgomery announced that because of the pressure of work in his own State of California, he would have to give up the chairmanship of the task force for at least six months. He would be able to continue as a member of the task force and as Vice Chairman. Ted Becker of Texas would be Chairman.

Minutes of the December 4, 1977 and April 6-7, 1978, meetings of the task force were approved, after correction of typographical errors.

Consumer Representation

There were no representatives present from the consumer groups which had asked for a discussion on consumer representation. Consideration of this question was therefore postponed.

Special Report to the (C3) Life Insurance Subcommittee

The task force reviewed the May 8, 1978, Special Report to the (C3) Life Insurance Subcommittee. Mr. Booth presented a substitute page 6 of Attachment C, "Actuarial Interpretation Regarding Minimum Reserves for Certain Forms of Term Life Insurance," correcting the mortality rates for females under age 20 to conform to those adopted by the NAIC in December 1977. (The female juvenile extension in the draft report had been computed by a different method from that eventually adopted.) The task force voted to accept the substitute.

Mr. Kelly suggested that the summary of the "Interpretation of Minimum Cash Surrender Benefit Under the Standard Nonforfeiture Law for Individual Deferred Annuities" refer to "individual deferred annuities with a surrender charge at maturity" rather than "no surrender charge until maturity." The task force voted to accept this change.

A number of typographical errors were pointed out and corrected.

The task force then voted to adopt the Special Report, as revised, recommending that the (C3) Life Insurance Subcommittee adopt the four actuarial guidelines proposed in the report and that the (C3) Committee recommend to the (A5) Financial Condition Examination Committee that the guidelines be included in the Financial Condition Examiners Handbook. It was noted that publication of the guidelines in the Handbook was not necessary to adoption of the guideliens, but would make them more accessible to state examiners.

Deposit Term Insurance

Mr. Booth distributed a substitute for part of the American Council's proposal with respect to deposit term insurance (item 1e of Attachment C of the regular report of the (C3) Subcommittee). The substitute revised and expanded the fourth of the proposed minimum disclosure requirements.

Mr. James Montgomery said that the substitute was an improvement but did not go far enough. He said that any attempt to relate the first premium to the endowment at the end of the term was misleading and should be prohibited. He recommended that the additional first-year premium not be shown separately, as proposed by the Council, but that the total premium for the basic policy be shown for each year.

Mr. Becker suggested that reference to applicable life insurance, annuity, or deposit fund disclosure requirements be added to the requirement for disclosing the amount of premium for each optional rider.

Mr. Minck suggested that relating the first-year premium to the endowment could be prohibited as part of the second disclosure requirement. After further discussion, the task force agreed on substitute language, suggested by Mr. Kelly and Mr. John Montgomery, for the second requirement, prohibiting any comparison between the endowment value of any specific cash value and the excess of the first-year's premium over the renewal premium.

Mr. Becker reported that the Texas Board of Insurance had withdrawn its ruling requiring minimum nonforfeiture values similar to those proposed, rather than go to court. He thought that other states might find that they lacked statutory authority for imposing the nonforfeiture value requirements. The task force reached no conclusion on keeping or deleting the proposed minimum nonforfeiture value requirements.

A copy of the proposed "Guidelines for Approval of Deposit-Term-Type Insurance," as revised is attached to these minutes. (Attachment A-1).

Other Guidelines for Life Insurance and Annuities

There was a lengthy discussion of the draft "Interpretation of the California Code – Actuarial Procedures," Attachment D of the regular report to the (C3) Life Insurance Subcommittee. Letters from John Booth (May 24, 1978) and Raymond Bierschbach (June 1, 1978) were distributed (Attachments A-2 and A-3 of these minutes).

It was suggested that item 3 be expanded to include the words "based on the assumptions at the initialization of the supplementary contract." There was no resolution of the question of interest guarantees in excess of the valuation interest rate.

It was noted that the task force had approved, at its April 6-7 meeting, a proposed revision to the Standard Nonforfeiture Law which would specifically permit the use of continuous functions in calculating minimum nonforfeiture values, prohibited by item 6 of the California draft.

It was recognized that the development of sex-distinct mortality tables would complicate the calculation of joint live reserves and cash values, item 7. The problem has not yet been addressed by the Society of Actuaries Special Committee to Recommend New Mortality Tables for Valuation.

Chairman Montgomery said that item 8 relating to reserves for convertibility and renewability would be redrafted, and there was no further discussion of the item.

It was suggested that items 9, 10, and 11 be combined to indicate more clearly that reserves are needed for each benefit whether there is a separate premium or not, and that riders must be valued separately. Mr. Montgomery agreed to do this. He remarked that each policy must have an adequate reserve; the aggregate reserve concept could lead to solvency problems if the mix of business changed.

It was noted that Item 13 was in conflict with the "Actuarial Interpretation Regarding Minimum Reserves for Certain Forms of Term Life Insurance," approved at this meeting.

It was suggested that Item 14 be expanded to read "reserve sufficiencies may not be offset against prior deficiencies."

The remaining items were not discussed in detail.

Construction of a New Mortality Table

Mr. Booth relayed a report from William K. Nicol (American National Insurance Company) on the progress of the Margins Subcommittee of the Society of Actuaries Special Committee To Recommend New Mortality Tables for Valuation. The subcommittee is experimenting with margins of the type used in the 1941 CSO Table (5 percent of the reciprocal of the expectation of life), the 1958 CSO Table ((0.75 + .01x) deaths per thousand at ages 0 to 32, $.15q_x$ at ages 62 + over, and margins graded by a cubic equation for ages 32-62), and a new variation which would produce margins of roughly 3 percent of the reciprocal of the expectation of life at the younger ages grading into 6 percent of the reciprocal of the expectation of life at the older ages.

They are trying several variations of each formula and comparing the loaded tables with company experience. They hope for a total reserve closely approximating that which would arise on a select and ultimate basis.

So far only the subcommittee has considered these margins. There will be a meeting of the full committee in July, and they hope for an initial exposure of the tables to the membership at the Society meeting in the fall.

Chairman Montgomery distributed a memorandum and table (Attachment A-4) showing the age setback, at quinquennial ages, of male values to obtain female values for various sex-distinct mortality tables. The setbacks required for mortality rates varied widely; those for complete life expectancies were more stable. He expects to compute the setbacks required for annuities and life insurance reserves, at various interest rates, at a later date.

John Montgomery, Chairman, California; Ted Becker, Texas; James Montgomery, III, District of Columbia; Larry Gorski, Illinois; Irma Edwards, Nevada; Thomas Kelly, New York; Bob Dolan, Pennsylvania; Bradford S. Gile, Wisconsin.

****

ATTACHMENT A-1

Proposed Guidelines for Approval of
Deposit-Term-Type Insurance

(Draft 2, as amended June 10, 1978)

[Editor's Note: The first draft appeared in the 1978 Proceedings V. II pp. 449-451. Only those sections which were changed appear here.]

Minimum Disclosure Requirements for Deposit-Term-Type Products

1. . . .

2. Any statement or illustration showing a comparison between the endowment value or any specific cash value and the excess of the first year's premium over the renewal premium which implies that such endowment or cash value arises solely from such excess constitutes a misrepresentation as to material facts. [In addition, in every case, full information relative to the initial deposit shall be given in writing to the applicant or prospective insured, which shall adequately disclose its amount, forfeiture details, guaranteed values and ultimate disposition under each future option required to be disclosed in 1.]

3. . . .

4. It is recommended that an "explanation" sheet be given to every applicant or prospective insured with pertinent figures inserted for the specific case showing [the amount of premium required for a particular mode of payment, the amount the premium becomes at the end of the deposit term; the amount of the initial built-in deposit, how and when it may be forfeited, its guaranteed nonforfeiture values, and its ultimate disposition.] the following amounts for each of the first twenty policy years and representative policy years thereafter sufficient to clearly illustrate the premium and benefit patterns.

a. The amount of the premium payable for the year for the basic policy.

b. The amount of the premium payable for the year for each optional rider. Any life insurance, annuity or deposit fund rider will be subject to the requirements for disclosure for life insurance, annuities, or deposit funds.

c. Guaranteed amount payable upon death, at the beginning of the policy year regardless of the cause of death other than suicide, or other specifically enumerated exclusions, which is provided by the basic policy and each optional rider, with benefits provided under the basic policy and each rider shown separately.

d. Total guaranteed cash surrender values at the end of the year with values shown separately for the basic policy and each rider.

e. Cash dividends payable at the end of the year with values shown separately for the basic policy and each rider. (Dividends need not be displayed beyond the twentieth policy year.)

f. Guaranteed endowment amount payable under the policy which are not included under guaranteed cash surrender values above.

Various options should be explained, with premium rates shown. The explanation sheet should set forth a reasonably complete picture of the plan. It would be advisable to have the applicant acknowledge receipt of the explanation sheet on a copy which would be kept by the insurer or its agent.

****

ATTACHMENT A-2

To: Mr. John O. Montgomery
Chief Actuary
California Insurance Department

From: John K. Booth
Associate Actuary
American Council of Life Insurance
Washington, D.C.

Date: May 24, 1978

Re: Interpretation of the California Code – Actuarial Procedures

We understand that you are seeking comments on the draft "Interpretation of the California Code – Actuarial Procedures," dated January 6, 1978 (see 1978 Proc. V. II p. 452). Therefore, we would like to make the following observations:

a. We have several concerns over the wording of interpretation no. 3 which would require supplementary contracts both with and without life contingencies to be governed by annuity reserve requirements. We regard supplementary contracts, particularly those written today where it is necessary to offer an attractive return in order for a company to obtain supplementary contract funds, as new contracts which should be subject to current reserve standards. For supplementary contracts which have high short-term interest guarantees and do not involve life contingencies, we believe liabilities should be based on valuation interest assumptions similar to those used in valuing interest guarantees under group annuity contracts. For those which involve life contingencies, we would suggest that reserves be based on the same standards that are applicable to currently issued individual single premium immediate annuity contracts.

Another concern we have with interpretation no. 3 is that it implies that liabilities for supplementary contracts not involving life contingencies are annuity reserves. This treatment would be contrary to the Federal Income Tax treatment of such contracts where they are considered as funds owed and insurers receive a deduction for interest paid on these funds.

b. We are not sure we understand the meaning or purpose of interpretation no. 6 in the light of the proposed revisions to the NAIC Standard Nonforfeiture Law. At the last meeting of the NAIC Technical Task Force, it was agreed that under the new NAIC Standard Nonforfeiture Law either curtate or continuous functions could be used in determining minimum nonforfeiture values. We assume that a company would not be prohibited from using continuous functions in determining its nonforfeiture values if such values exceeded minimum statutory requirements based on curtate functions. Furthermore, we believe that the intent of the Nonforfeiture Law is not to bar a company from using continuous functions to calculate minimum nonforfeiture values where these differ from those computed on curtate functions by only trivial amounts. Enclosed is a background memorandum by Harold Leff which was prepared in connection with earlier discussions of this subject.

c. It is difficult to understand interpretation no. 8 which ties the question of reserves for renewability or convertibility of a plan to rates published in the insurer's ratebook. While rates are one facet of renewal or conversion, the potential for antiselection, and the effect on that potential of the provisions and options under both the old and new plans are factors which must also be considered in establishing an appropriate reserve. Therefore, there may be considerably more actuarial judgment required in establishing proper reserves for conversions or renewals than in determining basic policy reserves.

d. Interpretation no. 13 appears to be contrary to the Actuarial Interpretation on term insurance reserves included in the Special Report of the NAIC Technical Task Force. We would hope that this language will eventually be supplanted by the "Actuarial Interpretation" which is included in the Special Report of the NAIC Task Force.

* *

To: Mr. Charles Greeley, Actuary

From: Harold Leff, Actuarial Associate

Date: June 14, 1976

Re: Appropriate Basis for Minimum Nonforfeiture Values

One of my assignments, stemming form the May 6th meeting of the Committee on Nonforfeiture Laws, was to examine the possible bases for calculation of nonforfeiture values to determine if one basis consistently produced the lowest value. These bases were age nearest birthday and age last birthday, and curtate and continuous functions, thus giving us four bases for nonforfeiture values.

Our study considered three plans (Ordinary Life, 20-Pay Life, and 20-Year Endowment) and three issue ages (20, 35, 50). Using the 1958 CSO and 3½% interest, we compared the cash values, duration-by-duration, for the four bases described above. While curtate/age nearest generally produced the lowest values for Life plans, curtate/age last generally produced about the lowest values for the Endowment. The results are explained in detail below.

Life Plans

The only instances where curtate/age nearest did not produce the smallest value on a Life plan occurred either where the value was actually negative, or at attained age 99. The first of these exceptions is obviously not significant, and the second appears reasonable in view of the following:

On an age last birthday, for attained age 99, the insured is age 99½, on the average; he is age 99, on the average, for an age nearest case. The present value of future benefits at attained age 99 is independent of the age basis, namely $\frac{1}{(1+i)}$ or v. However, the adjusted premium is lower on an age nearest basis. Since the nonforfeiture value at age 99 is present value of future benefits less present value of future premiums, or $v - p^A$, the curtate/age last basis produces a lower value due to the higher value of p^A on an age last basis. The difference between the two bases was only $.09, and this exception can, thus, probably also be ignored.

Endowment Plans

A generalization, comparable to that made for Life plans, cannot be made as easily for the 20-Year Endowment, as is evident from the following table:

Basis Which Produces the Lowest Nonforfeiture Values
for a 20-Year Endowment Policy (1958 CSO - 3½%)

Duration	20	35	50	65
1	cont./last	Always Negative Values		
2	cont./last	cont./last	curtate/last	curtate/near
3	cont./last	cont./near	curtate/last	curtate/near
4	cont./last	curtate/last	curtate/last	curtate/last
5-15	cont./last	curtate/last	curtate/last	curtate/last
16-19	curtate/last	curtate/last	curtate/last	curtate/last
20	Always $1,000.00			

We also analyzed the Endowment plan using the 1958 CSO at 4½% to see what effect a higher interest rate would have, and the results were essentially similar to that presented in the table above. No analysis was made using the Modern CSO table, since that table was only available on an age nearest basis.

Some generalizations which can be made regarding the 20YE are that (1) the curtate/last basis either produces the lowest value, or else it produces a value no more than $.39 above the lowest value; (2) curtate/nearest (the "best" basis for Life plans) produces values which are either lowest, or within $3.00 of the lowest.

****

ATTACHMENT A-3

To: Mr. John O. Montgomery
Chief Actuary
California Insurance Department

From: Raymond A. Bierschbach
Executive Vice President
Occidental Life Ins. Co.
Box 2101 Terminal Annex
Los Angeles, California 90051

Date: June 1, 1978

It is a shame that we didn't have more time to discuss the proposed "Interpretation of the California Code – Actuarial Procedures" (see last Proceedings, p. 452) at the recent meeting of the Actuarial Club of the Pacific States. Hopefully more time can be given to this subject at the September meeting. If you have been able to distribute the proposed guidelines by that time, we'll be in a better position to have a meaningful discussion. In the meantime, I'll send along some of my own comments.

As you know, interpretations No. 2 and 3 were applied to us when you were doing the audit of our 1976 reserves with the result that we did some reserve strengthening as of year-end 1977. Bob McCarty wrote a memo to file during the audit discussing the matter covered in interpretation No. 2. I'm enclosing a copy of Bob's memo.

Interpretation No. 8 is not clear to me. The first several times I read it I interpreted "such new policy" to be the term policy for which convertibility and renewability reserves may or may not be required. That interpretation results in confusion because I cannot see why the need for a reserve would depend on whether or not a policy is a regular rate book plan. A company could avoid a reserve merely by putting a policy in the ratebook.

Maybe, then, "such new policy" refers to the permanent policy issued as the result of a conversion. Are you then talking only of post conversion reserves? Also, isn't the need for a conversion reserve at least as much a function of the conditions of the term policy giving rise to the conversion as it is of the permanent policy that results? Also, under this interpretation, what would be "such new policy" when we're talking about renewability? And, finally, are you planning to set the required level of reserves using the guideline route? John, this is a pretty significant point and I feel more discussion, or at least clarification, of the intent of the guideline is needed.

Regarding interpretation No. 9, is it to apply only to such additional benefits as accident indemnity and waiver of premium? Companies have developed a wide variety of options that are built into policies without a separately identifiable premium charge and if all of these options are to be included within this guideline there could be a real honest difference of opinion as to the need for reserves.

Interpretation No. 10 is somewhat similar to No. 9. Perhaps some flexibility could be built into the guideline by adding some words such as "or the actuary must demonstrate that reserves are not needed."

As we discussed in Rancho Bernardo, the wording of interpretation No. 13 is in disagreement with the wording of the NAIC Technical Task Force. Perhaps you plan to revise interpretation No. 13 before implementing these guidelines.

John, thank you for soliciting industry reaction on these guidelines. Possibly others will want to give you the input you desire after they have had a chance to review them.

****

ATTACHMENT A-4

To: NAIC Technical Task Force To Review Valuation
& Nonforfeiture Value Regulation

From: John Montgomery, Actuary
California Insurance Department

Date: June 8, 1978

Re: Age Setback for Female Values

The attached table shows the age setback of male values to obtain female values for various sex distinct mortality tables. The ages are for every five years from male age 15 to 105.

Two sets of values were compared, one based on mortality rates and the other based on complete life expectancies. The latter showed more stability with increase in age.

The sets of tables used were:

1. The 1969-71 United States White male and female tables based on the 1970 U.S. census data.

2. Four sets of tables based on the experience of annuitants:

   (a) A – 1949 with no projection for improvement in mortality

   (b) A – 1949 with a projection for 30 years assuming an improvement in annuitant mortality

   (c) 1971 Individual Annuitants

   (d) 1971 Group Annuitants

3. Three sets of tables based on insured lives mortality, all of which were graduated basic unloaded mortality tables of the type that might be used as a basis for developing gross premiums for life insurance benefits.

(a) 1965-70 Ultimate Basic Table.

(b) 1970-75 Experience with experience in the first five policy years eliminated and with the male table having no hump in mortality at the late teens and early twenties.

(c) The same as (b) but with a hump in male mortality during the late teens and early twenties.

The 1970-75 Experience Table are those distributed to members of the Society of Actuaries Special Committee to Recommend New Mortality Tables for Valuation, March 31, 1978.

AGE SETBACK OF MALE VALUES TO OBTAIN FEMALE VALUES
FOR VARIOUS SELECTED MORTALITY TABLES

		Annuitant Mortality				Insured Life Mortality		
		A-1949	A-1949			1965-70	1970-75 Basic	
Male Age	1969-71 U.S. (White)	Not Projected	30-year Projection	1971 Individual	1971 Group	Ultimate Basic	Without Male Dip	With Male Dip
				PART A MORTALITY RATES				
15	2.56	N/A	N/A	N/A	N/A	2.67	6.50	5.00
20	6.64	N/A	N/A	N/A	N/A	5.53	6.33	8.00
25	11.48	13.10	13.00	N/A	N/A	10.93	9.67	12.55
30	15.85	7.89	7.89	12.14	12.14	15.07	11.33	16.69
35	19.44	6.10	6.09	8.97	8.97	18.21	11.25	20.29
40	6.91	5.38	5.38	7.65	7.65	3.23	2.77	2.71
45	6.07	5.04	5.04	7.00	7.00	3.80	2.88	2.88
50	6.71	6.20	6.20	7.42	7.42	4.68	3.94	3.94
55	7.61	7.92	7.92	7.92	9.16	5.98	4.43	4.43
60	8.53	8.70	8.64	7.73	9.65	6.57	6.41	6.41
65	9.22	8.06	7.48	8.77	8.61	7.98	6.49	6.49
70	8.70	6.20	5.44	8.05	7.60	7.81	6.83	6.83
75	7.09	4.77	4.15	5.42	6.02	5.29	5.61	5.61
80	5.18	3.68	3.20	3.54	4.83	4.24	4.88	4.88
85	3.78	2.76	2.42	1.90	4.78	3.58	3.19	3.19
90	3.07	1.94	1.75	.92	4.08	3.41	2.28	2.28
95	2.29	1.17	1.17	2.51	1.77	2.03	.34	.34
100	3.03	.44	.44	5.12	-.08	2.48	N/A	N/A
105	4.25	-.29	-.29	6.50	-.63	1.12	N/A	N/A
				PART B COMPLETE LIFE EXPECTANCY				
15	7.44	5.43	4.61	5.28	6.58	5.77	4.96	5.25
20	7.49	5.37	4.57	5.22	6.52	5.81	4.96	5.22
25	7.41	5.33	4.54	5.17	6.47	5.73	4.93	5.05
30	7.10	5.30	4.51	5.13	6.44	5.57	4.88	4.87
35	6.88	5.29	4.49	5.09	6.41	5.48	4.82	4.80
40	6.83	5.28	4.48	5.05	6.39	5.47	4.80	4.80
45	6.85	5.28	4.47	5.01	6.37	5.53	4.87	4.87
50	6.88	5.27	4.43	4.93	6.36	5.60	4.95	4.95
55	6.86	5.12	4.27	4.73	6.24	5.64	5.00	5.00
60	6.72	4.76	3.95	4.42	5.97	5.55	4.98	4.98
65	6.31	4.25	3.55	4.03	5.63	5.31	4.77	4.77

Male Age	1969-71 U.S. (White)	Annuitant Mortality: A - 1949 Not Projected	A - 1949 30-year Projection	1971 Individual	1971 Group	Insured Life Mortality: 1965-70 Ultimate Basic	1970-75 Basic: Without Male Dip	1970-75 Basic: With Male Dip
PART B COMPLETE LIFE EXPECTANCY Cont.								
70	5.61	3.72	3.15	3.44	5.21	4.73	4.45	4.45
75	4.65	3.19	2.74	2.77	4.72	4.01	3.86	3.86
80	3.84	2.65	2.32	2.12	4.25	3.65	3.17	3.17
85	3.05	2.10	1.88	1.61	3.83	3.21	2.22	2.22
90	2.69	1.52	1.44	1.95	2.62	2.79	1.12	1.12
95	2.52	.92	.92	3.68	.85	2.14	.11	.11
100	3.12	.29	.29	5.65	-.39	2.05	N/A	N/A
105	1.71	-.33	-.33	6.40	-.57	.28	N/A	N/A

****

ATTACHMENT B

(C) Committee Technical Task Force To
Review Valuation and Nonforfeiture Value Regulation

Life Insurance

Chicago, Illinois
October 25 and 26, 1978

The NAIC (C) Committee Technical Task Force to Review Valuation and Nonforfeiture Value Regulation met from 2:10 p.m. until 7:00 p.m. on October 25, 1978 in the Legislative Hearing Room in the State of Illinois Building, Chicago, Illinois, to consider matters pertaining to the (C2) Credit Insurance Subcommittee and to the (C1) Accident and Health Insurance Subcommittee. The task force met again from 8:30 a.m. to 2:00 p.m. on October 26, 1978, in the same place, to continue consideration of matters pertaining to the (C1) Subcommittee and to consider matters pertaining to the (C3) Life Insurance Subcommittee.

The following task force members were present: Ted Becker, Chairman, Texas; Erma Edwards, Nevada; Larry Gorski, Illinois; Thomas J. Kelly, New York; James R. Montgomery, III, District of Columbia.

Another State Insurance Department representative was present: Doug Broome, South Carolina.

The following persons were present for the Life Insurance (C3) meeting: James F. Allen; John K. Booth; Greg Carney, Anchor National Life; Grace V. Dillingham; Ann B. Enarson, Kemper; Jerome Golden, Equitable Life Assurance Society; Burnett Halstead, Kemper; George Harding, University Life; David Holland, Munich American Reassurance; Howard Kayton, Security First Group; Spencer Koppel; Harold Leff, Metropolitan Life; B. Pike, Dept. of Insurance, State of Illinois; Gary See, Washington National; Eugene Strum, TIAA.

The chairman announced that Bob Dolan was leaving the Pennsylvania Insurance Department and would be replaced on the task force by Thomas Bickerstaff of Pennsylvania.

Guideline on Deposit Term Insurance

Mr. Harding said that the Standard Nonforfeiture Law applied to deposit term policies until the law is changed. He urged the task force to delete the nonforfeiture portion of the guidelines, and asserted that there is no authority to change nonforfeiture requirements for deposit term insurance by regulation and that the present law is adequate. He also

expressed concern over the disclosure portion of the guidelines, saying he could support disclosure if it were not too onerous, but felt that year by year disclosure for 20 years should be required for deposit term and modified life policies only if required for all policies. He noted that for deposit term it would be of no particular value for many of the 20 years.

Mr. Carney referred to a paper, previously distributed to the task force, in which Mr. Alfred Guertin, who had been largely responsible for the development and adoption of the original Standard Nonforfeiture Law, said that deposit term insurance does not violate the spirit and intent of that law.

Mr. Booth reported that the Harding and Guertin papers had been discussed by the Actuarial Committee of the American Council of Life Insurance. The Actuarial Committee had made a number of changes in its recommendations. With respect to disclosure, it had agreed to use the phrase "partial endowment" rather than "deposit." This and other changes, all affecting language more than substance, were now being considered by the Council's Legislative Committee. With respect to nonforfeiture requirements, the Council's policy was in a state of flux. Its original recommendation grew out of the proposed new nonforfeiture law. It would have adopted, through the guidelines, the proposed method of calculating the expense allowance. The Actuarial Committee had reaffirmed its support of the proposed nonforfeiture requirements but, recognizing there might be questions as to the authority for adopting them through guidelines, now recommended only nonopposition to that portion of the guidelines. It also recommended that nonforfeiture requirements along the lines of those contained in the guidelines be incorporated in the 1976 amendments to the Standard Nonforfeiture Law in those states where they were still to be enacted. All of these recommendations were now being considered by the Legislative Committee and a more positive statement of Council policy would be made in December.

It was agreed that Mr. Booth would circulate the Council's new recommendations following the meeting of the Council's Legislative Committee. There would be one version with, and one without, nonforfeiture requirements. The task force deferred action until December.

Mortality Tables

Mr. See, a member of the Society of Actuaries Special Committee to Recommend New Mortality Tables for Valuation, reported that the Committee had completed both basic and loaded tables. The margins were based on large company experience and Monte Carlo simulations of small company experience in various reinsurance situations. The final report of the Committee was being prepared and would probably be distributed in late December or January.

Other Guidelines for Life Insurance and Annuities

There was discussion on the question of defining an annuity contract so as to distinguish it from a life insurance policy and determine unambiguously which nonforfeiture law to apply. However, this question was not resolved.

Revision of Standard Nonforfeiture Law

A letter from Mr. E. James Morton of John Hancock, transmitting a proposed new method for computing nonforfeiture values, was distributed. Since the task force had had no time to study the proposal, it was received for later consideration.

Variable Life Insurance and Annuity Plans

Mr. Golden submitted a report from the Variable Products Technical Advisory Committee. It contained proposals for variable annuities to make provision for expense charges on account of contractholder initiated transfers between the general and separate accounts and to give the company the right to cancel inactive contracts if the total of contributions made less partial withdrawals is less than $2,000. The Advisory Committee had been unable to reach a final decision on a question of providing for inflation in the per contract or per transaction charges. After a brief discussion, the task force decided to consider the matter in Executive Session.

Other Matters

There were no "problem plans" to be considered.

Mr. Kelly had reported that an interest factor (i_{my}) of .081, based on earnings data reported to the New York Insurance Department, should be used in determining 1978 reserve requirements for interest rate guarantees on group annuity active life funds where there were no guarantees in excess of 6 percent on future contributions to be received more than one year after the valuation data. (Where there were such guarantees, the factor should be .076.) The task force agreed that the chairman should inform the (A5) Subcommittee of the adoption of this factor so that it could be included in the Examiners' Handbook.

Mr. Gorski pointed out an ambiguity in the minutes of the December 4, 1977 meeting. According to these minutes: "... the Texas Directive [regarding the Valuation of Renewable Term Plans] applies to existing contracts whereas the ACLI version provides for a grading procedure for existing contracts. The ACLI five-year grading provision was discussed, however, it was determined that it should be left unchanged." On the other hand, a letter from John Booth, dated March 13, 1978, also included in the June 1978 Report of the Task Force, indicates that the five-year grading was deleted in October 1977. At its April 1978 meeting in Tampa, the task force proceeded on the assumption that the five-year grading provision had already been stricken out, and the guideline was ultimately approved without the grading provision. Mr. Booth said he believed there had been a vote, prior to the December meeting, to remove the grading provision, so that "unchanged" was correct. Mr. Booth and Ms. Dillingham were asked to research the matter.

Executive Session

The task force met in executive session from 8:30 a.m. to 9:40 a.m. on October 26 to discuss the Houghton-Wolf 1977 Medical Expense Tables and again from 2:00 p.m. to 3:00 p.m. on October 26 to discuss the report of the Variable Products Technical Advisory Committee.

Variable Annuity Nonforfeiture Regulation

The task force received Mr. Jerome Golden's October 25, 1978 paper containing two specific recommendations and four points for consideration related to provision for inflation in per contract or per transaction changes. The task force decided not to take any action at this time on the two recommendations. It agreed to request from Mr. Golden's Committee an analysis of the effects of inflation on expenses (including pertinent historical data) and the offsetting effect of asset charges being applied to increasing asset values. The task force also agreed to ask that the committee research the legal status of varying the expense charges by duration. It recommended that the committee consider the question of a specific charge for transfers between fixed and variable accounts from the standpoint of equity between the classes of contract holders who do and do not exercise their right to transfer.

Companies Earning Lower Interest Rates Than the Rate Assumed in Their Reserves

The task force had been requested by the Alabama Insurance Department to consider the definition of an appropriate additional reserve to be required of companies which are unable to earn interest at the rates assumed in the reserves presently being set up in the company's annual statement. Mr. Thomas K. Pennington, Senior Vice President and Actuary of Protective Life Insurance Company, had submitted a proposed method for determining the need for such reserves and computing the reserves.

****

ATTACHMENT E

To: Mr. Ted Becker
Staff Actuary
Texas State Board of Insurance

From: John K. Booth
Vice President and Chief Actuary
American Council of Life Insurance
1850 K Street, N.W.
Washington, D.C. 20006

Date: November 8, 1978

Re: (1) Council's Deposit Term Guidelines.
(2) Five-year Grade-in of Additional Reserves for Certain Term Insurance.

Enclosed are two exhibits which contain the disclosure and minimum nonforfeiture guidelines for partial-endowment-type ("deposit-term-type") insurance. These are shown in comparison form to indicate the changes which were made at the October 26, 1978 meeting of the Council's Legislative Committee from the guidelines we submitted to the NAIC Technical Task Force in April 1978. *[Editor's note: reprinted here in clean text form.]*

The Legislative Committee reaffirmed our support for the disclosure guidelines as modified, and adopted a recommendation of the Council Actuarial Committee that Council policy be changed from active support of the minimum nonforfeiture guidelines to one of nonopposition to such guidelines. The Legislative Committee also approved the Actuarial Committee's recommendation that the Council support legislation sponsored or initiated by others to require minimum nonforfeiture benefits for partial-endowment-type ("deposit-term-type") insurance along the lines of the Council's proposed guidelines as part of the package of 1976 amendments to the Standard Valuation and Nonforfeiture laws, provided such legislation would not appear to jeopardize passage of these amendments.

With respect to the question raised as to the action taken by the NAIC task force on the five-year grade-in provision in the Actuarial Interpretation Regarding Minimum Reserves for Certain Forms of Term Life Insurance, my notes from the October 22-23, 1977 meeting of the task force indicate that the task force agreed to strike the five-year grade-in provision from the Council's proposal. However, the NAIC proceedings shows that no such action was recorded in the final minutes. At the December 4, 1977 meeting of the task force, the minutes indicate that the five-year grade-in provision was left unchanged. (See the last paragraph on p. 443 of the 1978 Proceedings V. II.) The wording is unclear as to whether the five-year grade-in of the original Council proposal was to be left unchanged or whether the deletion of the five-year grade-in from the proposal was to be left unchanged. As further background, the copies of an attachment to the agenda for the December 1977 meeting of the task force shows a question mark opposite the five-year grade-in provision of the Council's proposal. This may indicate some doubt as to whether or not this provision was to have been included in the final actuarial interpretation.

In summary, it appears that the written record of the NAIC task force's action on the five-year grade-in provision is somewhat vague, but in presenting a revised proposal to the task force in April 1978, we relied upon our unofficial notes that the task force had agreed to strike the five-year grade-in provision at its October 1977 meeting and therefore we omitted this provision.

ACLI Draft Proposed Disclosure Guidelines for Approval of Partial-Endowment-Type Insurance

October 2, 1978

Scope

These guidelines deal with those annual premium individual insurance products which require the payment of a premium in the first contract year higher than a level series of premiums in the renewal contract years. The excess of the first year premium over the renewal year premiums is sometimes described as a "deposit." "Deposit term insurance." "deposit whole life insurance" and "modified premium whole life insurance" are names which are typically given to these products, but these guidelines apply to all products of the type described irrespective of the name given to the coverage.

Description of Partial-Endowment-Type Products

Partial endowment insurance generally involves the payment of a relatively higher first-year premium as compared to renewal year premiums. The excess of the first year premium over renewal year premiums is often mistakenly characterized as an initial "deposit" which is returned to the policyholder at the end of a selected period of years, usually eight or ten, increased by what is often alleged to be interest.

"Modified premium whole life" is similar at the outset, except that there is an "automatic attained age conversion" to a whole life plan at the end of the initial period. The maturity value that is normally payable at the end of a partial endowment contract may or may not be payable at the time of automatic conversion.

After the conversion, if the maturity value of the "precursory contract" is not payable at the time of automatic conversion, the nonforfeiture values of the whole life policy may or may not be augmented by the value of the maturity value. Some converted policies provide nonforfeiture values which progress so that the maturity value gradually disappears over the life of the whole life policy. Modified premium whole life policies generally offer the policyholder the option to "roll over" the maturity value and start a new modified premium whole life policy instead of continuing on the automatic track. In this case the maturity value from the precursory coverage is used as the "additional first year premium" for the new coverage. Thus, it is possible for a modified premium whole life insurance policy to be rolled over several times so that it in effect becomes a series of renewable partial endowment insurance coverages.

The nature of partial-endowment-type products is such as to enhance the possibilities of misunderstanding unless such products are carefully sold and fully explained. For this reason, these guidelines set forth minimum disclosure requirements for partial-endowment-type products.

Minimum Disclosure Requirements for Partial-Endowment-Type Products

1. All advertisements, sales materials and sales presentations of partial-endowment-type products which fail to fully and fairly inform an applicant or prospective insured as to future premium changes, benefits and related options constitute a misrepresentation as to material facts.

2. The use of any statement or illustration in any advertisement, sales material, or sales presentation which makes reference to such terms as "deposit," "accumulation," "interest at x%," and all similar terms associated with fund accumulations and investment contracts where life contingencies are involved constitutes a misrepresentation of material facts.

3. The name given to partial-endowment-type products shall not include any term that implies a "deposit" or any similar term associated with fund accumulations and investment contracts.

4. Any statement or illustration showing a comparison between the endowment value or any specific cash value and the excess of the first year's premium over the renewal premium which implies that such endowment or cash value arises solely from such excess constitutes a misrepresentation as to material facts.

5. If the policy contains a provision permitting the making of voluntary deposits which will accumulate at interest, the nature thereof shall be disclosed, and such disclosure shall distinguish such deposit provision and the insured's rights thereunder from the "additional first year premium."

6. It is recommended that an "explanation" sheet be given to every applicant or prospective insured with pertinent figures inserted for the specific case showing the following amounts for each of the first twenty policy years and representative policy years thereafter sufficient to clearly illustrate the premium and benefit patterns:

   a. The amount of the premium payable for the year for the basic policy.

   b. The amount of the premium payable for the year for each optional rider. Any life insurance, annuity or deposit fund rider will be subject to the requirements for disclosure for life insurance, annuities, or deposit funds.

   c. Guaranteed amount payable upon death, at the beginning of the policy year regardless of the cause of death other than suicide, or other specifically enumerated exclusions, which is provided by the basic policy and each optional rider, with benefits provided under the basic policy and each rider shown separately.

   d. Total guaranteed cash surrender values at the end of the year with values shown separately for the basic policy and each rider.

   e. Cash dividends payable at the end of the year with values shown separately for the basic policy and each rider. (Dividends need not be displayed beyond the twentieth policy year.)

   f. Guaranteed endowment amounts payable under the policy which are not included under guaranteed cash surrender values above.

Various options should be explained, with premium rates shown. The explanation sheet should set forth a reasonably complete picture of the plan. It would be advisable to have the applicant acknowledge receipt of the explanation sheet on a copy which would be kept by the insurer or its agent.

7. In the case of replacement situations, the required replacement disclosure statement must be filled out so that premium changes and/or options at the end of the partial endowment period are fully and fairly disclosed to the applicant. This may be done on the replacement disclosure statement itself, in the "premiums" section, for example, or may be shown on a supplemental section attached to the statement.

8. It is the responsibility of the insurance company to see that the public is given a true and complete disclosure of partial-endowment-type plans in clear and unambiguous terms. Each company should examine its own particular products to determine how it can most effectively meet its responsibility.

ACLI Draft Proposed Minimum Nonforfeiture Guideline
Requirements for Approval of Partial-Endowment-Type Products

October 2, 1978

The intent of the Standard Nonforfeiture Law is to prevent unjustified forfeitures by terminating policyholders of their equities in their policies. The law fixes a minimum floor for nonforfeiture values on the basis of a rough approximation of their equity in the contract which was defined as follows by the NAIC Committee To Study Nonforfeiture Benefits and Related Matters:

> Nonforfeiture benefits may be said to be equitable when they are established at such a level that the withdrawing policyholder will receive a benefit, be it cash or some form of continuing paid-up insurance, which will be as nearly as possible equivalent to his contribution to the funds of the company less the cost of the protection which he received and less the cost of introducing and maintaining him as a policyholder and which will not exceed the largest amount which can be paid to him without impairing the equities of the remaining policyholders of the company. (Reports and Statements on Nonforfeiture Benefits and Related Matters, Actuarial Society of America and American Institute of Actuaries, 1942, p. 58.)

The intent of the law, as stated above, is that the excess initial expense allowance used to define minimum nonforfeiture values for partial endowment insurance shall not be based upon the "additional first year premium," since an increase in the first-year premium does not, in itself, increase the cost of protection or the cost of introducing or maintaining the insured as a policyholder. Therefore, nonforfeiture values under partial endowment policies shall be at least as great as those calculated by applying the Standard Nonforfeiture Law to the policy but substituting a net level annual premium in place of the adjusted premium for the first policy year in the determination of the excess initial expense allowance. Such a net level annual premium shall be equal to the present value, at the date of issue of the policy, of the sum of the guaranteed term insurance benefits provided for by the policy up to the end of the term period plus the endowment benefit provided for by the policy at the end of the term period divided by the present value, at the date of issue of the policy, of an annuity of one per annum payable on the date of issue of the policy and on each anniversary of the policy on which a premium falls due up to the end of the term period.

In the case of modified premium life insurance which is essentially term insurance followed by permanent, minimum nonforfeiture value requirements shall be determined by applying the Standard Nonforfeiture Law separately to the term coverage period and the whole life coverage period, irrespective of any language in the policy which states that the conversion to whole life coverage is automatic or that the coverage period is continuous. If an endowment is not paid out in cash to the policyholder upon conversion to whole life insurance, minimum nonforfeiture values for the whole life insurance policy shall not be less than those computed under the Standard Nonforfeiture Law for the whole life insurance coverage plus the amount of the endowment benefit at the time of conversion accumulated at a rate of interest specified in the policy for accumulating that benefit.

In the case of partial-endowment-type products which differ from those described above, the procedures for determining minimum nonforfeiture requirements under this guideline shall be appropriately modified to perserve the intent of the Standard Nonforfeiture Law.

In no event shall the calculation procedures set forth in these guidelines be construed as permitting any nonforfeiture value lower than those which would otherwise be required in the absence of these guidelines.

Examples of minimum nonforfeiture values required by this guideline follow.

Examples of Minimum Nonforfeiture Values Required Under the
Guidelines for Approval of Partial-Endowment-Type Products
Partial Endowment 8 Year Renewable and Convertible Term

	1958 CSO – 4% Curtate Issue Age 35		
	Case I	Case II	Case III
Term Insurance Benefit:	$1,015.00	$1,030.00	$1,100.00
[Pure] Endowment at End of Term:	15.00	30.00	100.00
Annual Level Gross Premium:	4.49	4.56	4.87
"Additional First Year Premium" [(Deposit)] :	7.50	15.00	50.00
Net Level Annual Premium:	4.63	6.22	13.61
First Adjusted Premium:	17.20	28.43	82.05
Renewal Adjusted Premium:	6.44	6.63	7.28
	Minimum Nonforfeiture Values		
Duration			
0	-23.32	-24.68	-30.83
1	-8.93	1.32	50.63
2	-5.28	5.57	57.48
3	-1.64	9.83	64.45
4	1.94	14.06	71.50
5	5.43	18.23	78.61
6	8.79	22.29	85.75
7	11.99	26.23	92.88
8	15.00	30.00	100.00

****

ATTACHMENT F-1

Forms of Policies Providing for a Supplementary
First Year Premium Not Dependent on Age

by
Alfred N. Guertin

Princeton, New Jersey
August 23, 1978

The development by a number of companies of policies containing provision for an additional first year premium and providing a fixed payment at the end of a fixed term period coupled with term policy or life insurance policy has provided a substantial amount of discussion in company, agency and supervisory circles. The purpose of this memorandum is to examine the product, its compliance with statutory standards as to reserves and cash values, any inequities from the standpoint of the policyholder and some attention to marketing methods that may have resulted in criticism.

There are several forms of policies in the general plans considered here. They can be grouped into two categories. Variations in the forms will not invalidate the principles developed.

The first plan considered is the so-called "deposit term." This is a policy providing a level death benefit for a specified number of years equal to a basic amount increased by a supplementary death benefit equal to a maturity value which is a small percentage of the basic amount. There is then a level premium following a higher first year premium. The more common forms are as follows:

Term of Policy	Basic Amount	Additional Premium	Maturity Amount	Death Benefit
10 years	$1,000	$10.00	$20.00	$1,020.00
15 years	1,000	10.00	30.00	1,030.00
20 years	1,000	10.00	50.00	1,050.00

The second plan considered is a policy for the whole of life with at least three levels of premiums. It is similar to the first plan during the first two periods but, instead of the maturity amount being available as an endowment, an amount corresponding to a maturity value appears as an initial cash value of a continuing whole life policy at the beginning of the 11th year. Such cash value permits reduction of the premium thereafter below that which would otherwise be applicable at the then attained age. After the 10th year, the amount of insurance is the basic amount, the supplementary insurance having terminated. After the 20th year, the cash values are higher than a similar policy purchased at that date. Of course, such a policy could be written with modified periods of other than 10 years. Reserves with reference to the 10 year type hereafter made would apply equally to other yearly types.

Deposit Term Policies

These forms are examined because there is criticism that (1) early cash values do not reflect the "deposit" (2) the policies are erroneously represented as involving a "side fund" which accumulates at a high rate of interest (3) such misrepresentations are used to effect "twisting" of existing life insurance and (4) such twisting is encouraged by the payment of excessive first year commissions on such policies. Each of these points will be discussed separately.

Generally, such contracts contain cash values that are calculated according to the requirements of the Standard Nonforfeiture Law. The formula is identical with that used for all policies of insrance. The "deposit" is not "lost" to the policyholder any more than the policyholder who lapses a 20 payment life policy at the end of the first year loses more than the policyholder who lapses a whole life policy. The loss of the "deposit" is no more of an imposition on the policyholder than the loss of the excess of a 20 payment life premium over a whole life premium is to the holder of the 20 payment life policy.

Such forms of policies are discussed with reference to the present requirements as to reserves, cash values and statutory limitations applicable thereto. Some of these discussions will involve the background of such statutory limitations.

A question arises. It is prompted by allegations as to representations made by companies and agents. "Would it be possible to devise a policy where the 'deposit' could be accumulated at interest?" The answer is "Yes, but it would be impractical." In fact, a company could devise a rider, attached to a 20 year term policy which would require a simple deposit of $10.00 to accumulate to $50.00 at the end of 10 years. The death benefit would be the basic amount plus the accumulated amount at the date of death. The interest rate would be 8.379%. Such a plan would be impractical even if the company was willing to guarantee the 8.379% rate as indicated hereafter.

It should be observed that the foregoing contemplates that the contract may be looked upon as consisting of two different benefits (1) the "deposit" accumulation fund and (2) a term policy. Thus one part of the contract is an "investment contract" and the other part is a term policy.

The statutes would appear to restrict the rate for calculating the reserve on such an accumulation to 4½% (4% in some states). At issue, the required reserve at 4½% on the investment portion would be $20.23, an amount to be set up as a liability on receipt of the $10.00 "deposit." It is maintained in some quarters, that such a fund should carry a cash value "appropriate" to the amount of the "deposit." If the cash value were taken to be the discounted maturity value and were to be calculated at, say, 8.628%, the cash values would grade from $9.55 at issue to $50.00 at maturity. Presumably, this might be "appropriate." However, it should be noted that cash value would need to be defined as the discounted maturity value at 8.628%. Further, the reserve would still need to be calculated at 4½% as shown above.

A legal question could be raised. Life insurance companies are generally authorized and restricted to the issue of contracts involving life contingencies. This is usually interpreted as meaning the assumption of the risk of death in the case of insurance policies or of the risk of survival in the case of annuities. Neither of these risks is involved in the "deposit" portion of the policy as described above.

It should be observed that it is not unusual, particularly in pension cases, for provision to be made for the accumulation of "side funds." This is usually done by amendment to the basic policy. Contributions to such "side funds" usually become premiums under the policy and the accumulation of such funds provides additional annuity at the pension date. Thus, it will be seen that the risk of survival is involved in the case of a "side fund" both from the standpoint of the guarantee of an annuity rate far into the future and of the survival rate thereafter. Hence, a "side fund" does involve life contingencies. A "deposit" as herein described does not.

It is understood that a number of states have taken the position that, while "side funds" which involve life contingencies are within the underwriting powers of life insurance companies, the issue of a savings contract, as such, is outside the corporate powers of a life insurance company. "Investment Contracts" involving interest alone form a regular part of the life insurance business in Great Britain, but this is not so in most states. The applicable state law is the criterion in this respect.

It is thus seen that it is impractical to separate the policy into two parts so that an accumulative deposit of the type described can accrue to the policyholder. The benefit would not be "self-supporting." Hence, support must be looked for in the other part of the contract. Such support is found in an increase in the premium for the term insurance over and above the premium which would be charged for the term insurance alone. When this is done, the "deposit" concept is lost. It can no longer be said that the $10.00 deposit accumulates to $50.00 at the end of 20 years. Neither can it be said that the $10.00 deposit accumulates at a rate of interest of over 8¼%.

Term Policy With Supplementary Paid Up Endowment

There is another way that the policy could be construed. It could be regarded as a term policy with a supplementary paid up endowment. With such an interpretation, the use of the expressions "deposit term," "deposit," "accumulation" and other expressions associated with an accumulative fund becomes invalid. The definition indicated would not be an inaccurate description of the policy if the single premium endowment were self-supporting and the term insurance portion carried a regular term premium. However, this qualification does not exist in the policies under examination.

The above definition contemplates a contract divided into two separate parts, each of which is complete in itself. However, the paid up endowment part is not self-supporting as will be shown below. Assume that a separate valuation of the single premium endowment is made. The net single premium or initial reserves for the endowment benefits are as shown below. Calculations are on the basis of the 1958 CSO table with 3½% interest. The relationship developed would be the same, except for differences quantitatively, if other or higher interest rates were used.

Age At Issue	10 Year Contract	15 Year Contract	20 Year Contract
25	14.23	17.63	25.60
40	14.27	18.27	26.32
55	14.57	19.29	29.30

It is thus seen that the company becomes required to set up a reserve initially in amounts considerably in excess of the $10.00 premium received therefore. The initial values shown above grade into the maturity value. The Standard Nonforfeiture Law sets up a maximum rate of interest for calculating nonforfeiture benefits. If that rate were 3½%, cash values for the supplementary benefit would also be equal to the reserve amounts described above. Obviously, this would create an impossible situation for the company concerned.

Issue of such a policy becomes practical only if the renewal premium contains a factor to support the endowment. In that case, the two parts of the contract become inseparable. It becomes a single contract which cannot be properly called a term policy with a supplementary paid up endowment benefit. It must be called by an appropriately descriptive name.

Partial Endowment With Additional First Year Premium

The combination contract here considered is not a term policy, at all. It is a partial endowment. The policy is one with a high first year premium and a maturity value of less than the death benefit. It can be written for any combination of excess of first year over subsequent premiums. The supplementary death benefit and maturity amount may be any amount less than the amount of basic term insurance. The situation of a 20 year policy, where there is an excess of first year premiums over subsequent premiums is $10.00 and the maturity amount is $50.00, is merely a special case of a more general form in which relations are different in quantitative amounts only. As a matter of fact, a partial endowment is a sort of a reflection of a retirement income policy. In one case, the maturity value will exceed the face amount. In the other case, the face amount exceeds the maturity value. Theoretically, both could be written with a first premium in excess of renewal premiums.

There is no problem involved here as to compliance with state law. This is a contract, all parts of which involve life contingencies. It is treated for the calculation of reserves and cash values as a unit just like any other policy. In fact, the Standard Nonforfeiture and Valuation Laws, generally effective in 1948, definitely recognized the issue of contracts with irregular premiums and specific provisions were inserted in those statutes to deal with them. The provision that adjusted premiums must bear a constant ratio to gross premiums accomplishes this.

In the case of this form, there is only one reserve. The net premium covers both the death benefit and the endowment benefit and bears a fixed proportion to the yearly gross premiums under the policy. The Standard Valuation Law is applied directly and the required reserve emerges as a result of direct calculation. The approach is completely consistent with the Standard Valuation Law which requires valuation of a contract as a whole and does not regard a reserve as made up of the sums of the reserves of the constituent parts of a policy as meeting minimum standards unless that total is in excess of the minimum calculated as specified.

For this contract, there is a unique reserve and unique cash value for whatever actuarial basis selected. At age 40, according to the 1958 CSO table and 3½% interest, the basic gross premium is taken to be $13.23. Accordingly, the renewal premium bears a ratio to the total first year premium of .5695. The minimum cash values and reserves are given below:

Policy	Reserves	Value
1	13	-18
2	19	-11
3	25	- 4
4	30	3
5	36	9
6	41	16
7	46	22
8	51	28
9	55	34
10	59	40
11	63	44
12	65	49
13	67	52
14	69	55
15	69	57
16	68	57
17	66	58
18	62	56
19	57	53
20	50	50

Certain points may be developed. The differences between the reserves and cash values correspond to what may be regarded as a "surrender charge." It is a matter of reasonable expense levels as to whether these are excessive or inadequate. However, they are consistent with minimum values required for other types of policies. Companies issuing such contracts generally maintain that the values they allow, which are at least as large as values calculated as indicated above, are fully supported by asset share calculations reflective of appropriate experience factors. The values so supported are usually consistent with the pattern above illustrated.

A further observation should be made. Since this is not a level term policy meeting the time termination specified in the statutes, originally 15 years and terminating before age 66, the forfeiture implicitly allowed in level premium short term policies is not available to the company. As a result of this, the pattern of the cash value is changed so that cash values actually exceed the maturity value at some durations. In the example shown, this situation occurs from the 13th to the 20th years with a maximum in the 17th year. In other words, certain values not available to the holder of a term policy are salvaged to the holder of a policy such as this.

To illustrate the fact that the policy is merely a special form of a partial endowment, the following figures will show how the cash values range under different combinations of additional first year premiums and maturity values. To facilitate the calculations, ratios of renewal gross premiums to first year gross premiums not being available, ratios of representative levels were used and are shown below:

		I	II	III	IV	V
Basic amount		1,000.	1,000.	1,000.	1,000.	1,000.
Addn't end't amount		50.	100.	750.	100.	10.
Additional first prem.		10.	10.	10.	25.	15.
Ratio ren's to first prem.		.5695	.6061	.8142	.3831	.3433
Cash values end	1 year	0	0	0	0	0
	2 years	0	0	13	0	0
	3 years	0	0	47	6	0
	4 years	3	9	83	15	0
	5 years	9	18	119	24	5
	6 years	16	26	156	32	10
	7 years	22	35	194	41	15
	10 years	40	60	311	64	26
	13 years	52	81	435	84	33
	16 years	58	96	565	98	31
	20 years	50	100	750	100	10

The pattern above illustrates that all elements of a policy enter into the calculation of cash values. To single out any specific element with respect to any particular policy form for special treatment is to introduce discriminatory elements as to the various forms. This principle is fundamental to the maintenance of equity as between the various forms of policies. If the basic formula is defective, then it must be defective over all and it should be examined with respect to all forms of contracts and not with respect to particular policy forms only. Certainly, adjustment should be made on the basis of mathematical equivalence and not on the basis of individual notions as to what levels cash values should occupy.

Requirements of the Standard Nonforfeiture Law

A review of the considerations that were taken into account by the Committee to Study Nonforfeiture Benefits and Related Matters of the NAIC is pertinent to the problem with which this memorandum is concerned. These considerations apply now as much as they did at the time. The evils sought to be cured then did not reappear after enactment of the Standard Nonforfeiture and Valuation Laws.

During and prior to the period of the deliberations of that committee, the then current use of the combination of the Illinois Standard valuation and the statement required to be contained in preliminary term policies to the effect that "The first year's insurance under this policy is term insurance purchased by the whole or a part of the premium for the first policy year" was carefully considered by the committee. Where there was a level gross premium, the additional margins for additional first year expenses contained in such policies were regarded as reasonable for policy reserve purposes by the committee.

However, over the years, there were developed a number of methods of constructing policies so that the first year margin could be amplified without increase in the required nonforfeiture benefits. Among the methods, the most well known were the following, all valued on a preliminary term basis.

1. A whole life policy with a high first year premium.

2. A coupon whole life with 20 coupons paid for but 19 coupons accumulated to the 20th year.

3. A policy with high premiums for 20 years with a series of 19 pure endowments ending with this 20th year.

4. Any combination of the above, sometimes with a limited period return premium death benefit.

It will be seen that in the case of the first form mentioned, the margins for first year expenses was increased over normal by the excess of the first year gross premium over the renewal gross premium. In the case of the second and third forms, the first year expense was either increased by the amount of a coupon or the cost of one year's pure endowment. The fourth category showed much ingenuity in the development of forms designed to produce excessively high expense margins. If net level reserves were maintained on such policies, they were often calculated as if the premiums were level. Thus, there were available additional margins created by the use of complicated benefit structures and irregular premiums.

It was for reasons concerned with these problems that led to the creation of the formula used in the Standard Nonforfeiture Law and the Commissioners Reserve Valuation Method. In both of these, the net premium in the case of minimum reserve valuation, and the adjusted premium, in the case of the calculation of minimum nonforfeiture benefits, must bear constant percentage relationships to the gross premiums. The effect of this is to require that the total premium in every year must be reflected in the calculation of reserves and minimum nonforfeiture benefits.

The Hooker Committee, an NAIC committee, applied this requirement to "special policies" exactly as written. Its report, dated December 10 to 15, 1950, reaffirms the application of this concept.

"Deposit" Life Policies

These forms, whole life with preliminary term and modified whole life, both with a "deposit"premium and a fixed cash value at the end of the preliminary term or modification period are policies of a somewhat different sort. But, they present exactly the same problems as the "Deposit" term policies.

Often these will take the form of a policy of a high first year premium, a low premium for five or ten years and higher premium beginning in the tenth year. There may even be a change in the premium in a later year period. Policies with varying amounts and variable premiums were definitely recognized in the Standard Nonforfeiture Laws and the formula for cash values specifies a unique value for any variations up or down in premiums or benefits through the requirement that adjusted premiums be proportional to gross premiums and that an "equivalent level amount" be used in the process of calculating such adjusted premiums.

Evidence of forfeiture of any benefit, if the statutory formula is correctly applied, beyond the limits specified in the statute will not appear. The fact that cash values may not appear for a long period of years, 10 years in some cases, is not material. Even if there were no "deposit" and all the premiums for the first ten years were increased accordingly, there might well be no cash values during such period in spite of the increased gross premiums if the policy were constructed so as to defer the impact of high premiums for a period chosen to bring this about. Such choice would merely make higher values available at later durations.

As in the case of a 10 year "Deposit Life," there is no natural relationship between the supplementary first year premium and the tenth year cash value. The former and the latter may be set at any levels desired, within reason. This may result in cash values of minute amounts which would increase and decrease during the preliminary period but build up to the tenth year cash value.

These policies do not fall into the conventional pattern of level premiums with which the public is generally familiar. They are complicated and difficult for the public to understand. However, they can fit particular circumstances if properly explained. There is nothing objectionable to the policy itself. However, it is probably susceptible to the same misrepresentations as the "Deposit Term" and may be treated in the same way.

It is seen that some of these policies provide that the cash value at the end of the 10th year will be double the additional first year's gross premium. This provides an opportunity to represent that such additional premium is accumulated at more than 7%, even though no cash value is available during the intervening years. This representation should not be permitted. A policy thus designed is sufficiently sound to stand on its merits and not on misrepresentation.

A typical policy will provide for a "deposit" of $10.00, a death benefit for ten years of $1,010 and $1,000 thereafter for life. It will have provision for a cash value of $20.00 at the end of the tenth year which may be taken in cash or the policy automatically continued at a somewhat reduced premium compared to the standard attained age rate and with increased cash values.

For purposes of illustration, such a policy at age 40, without the $20.00 cash value, and with the same gross premiums was used. The first year gross premium used was $16.61 followed by nine renewal premiums of $6.61 and subsequent renewals of $33.25. It developed that the first positive minimum cash value appeared at duration eleven and stood at $4.13. The minimum cash value at the end of the tenth year was $-18.70.

If there were no special guaranteed cash value at the end of the tenth year, the minimum cash values would be such as are indicated in the following table.

Policy Year	Cash Value	Policy Year	Cash Value	Policy Year	Cash Value
1	$-19.61	6	$-14.35	11	$ 4.13
2	-17.93	7	-14.51	12	27.21
3	-16.52	8	-15.23	13	50.49
4	-15.43	9	-16.59	15	97.59
5	-14.69	10	-18.67	20	217.20

It is obvious that an accumulation of adjusted premiums of the above amounts will not support a cash value of $20.00 at the end of the tenth year.

If a cash value is to be built up in the tenth year, it becomes necessary to modify the formula in a way that will recognize the existence of such a vlaue as a "benefit under the contract." Doing so, in effect, distorts the "adjusted premium" calculation to the extent that the adjusted premiums become $22.99 in the first year followed by nine renewals of $9.11 and $28.26 thereafter.

On the basis of the calculations made, the cash values during the first ten years, according to such arrangements are shown in the following table.

Policy Year	Cash Value	Policy Year	Cash Value	Policy Year	Cash Value
1	$-16.32	6	$ 6.83	11	$ 41.94
2	-11.17	7	10.68	12	64.15
3	- 6.37	8	14.14	15	131.85
4	- 1.75	9	17.16	20	246.92
5	2.67	10	20.00	30	468.95

This clearly shows that minimum cash values will be built up in several of the years prior to the tenth.

The fact that adjusted premiums exceed the gross premiums immediately raises a question as to the levels of net premiums. On the same assumptions, the first year net premium is $14.12 and the subsequent nine years have net premiums of $5.62. The net premium after the tenth year is the same as the adjusted premium for that period. The table below shows the reserves.

Policy Year	Cash Reserve	Policy Year	Cash Reserve	Policy Year	Cash Reserve
1	$11.09	6	$20.22	11	$ 41.94
2	13.47	7	20.98	12	64.15
3	15.61	8	21.24	15	131.85
4	17.47	9	20.92	20	246.92
5	19.03	10	20.00	30	468.95

The effect of the treatment shown above is to regard the contract as a partial endowment for ten years followed by whole life insurance at a rate below the attained age rate otherwise adopted and with cash values exceeding those otherwise available on a policy issued at the then attained age.

The pattern of partial endowments above shown illustrates the relationships between the various functions and the effect of the application of the Standard Nonforfeiture Law to all policies irrespective of quantitative size of benefits or of the relative sizes of the various premiums. To single out any one of the family of policies for favorable treatment is illogical and discriminatory and can only favor persons acquiring such policies against holders of other policies.

Marketing Problems

Review of literature dealing with this problem appears to focus on the contract itself as well as to methods of marketing used at the company and agency levels alike. State insurance departments, apparently, are interested in what appears to be an inequity, that is, a single first year charge appears not to be reflected in early cash values. Others, as well as such departments, appear to be interested in marketing and distribution problems.

This study focuses principally on the form of the contract itself. It is shown that the policy itself contains no element of excessive charges against the premium not recognized in the statutes. In fact, the policy is self-supporting in exactly the same way as other policies and values thereunder are determined in exactly the same way.

Criticisms are made to the effect that there are no cash values in the early years. But this is not a rarity. Some types of five year initial term permanent plan policies will have no nonforfeiture values during the five year period. A modified life policy where the premium during the modification period is quite low is likely not to have nonforfeiture benefits during such period. Like the policies under consideration, all premiums on such policies are taken into account, as of their respective dates of payment, in the calculation of nonforfeiture benefits.

It is not lack of conformity with statutes that is at the root of the criticisms, it appears to lie in an expectation that these policies are "special" in the sense that they are better or cheaper than other policies with which the public is familiar. They are not "better" as some literature and representations would seem to indicate, nor are they worse as some regulatory officials maintain. A 20 year endowment is not a proper substitute for a life policy for some policyholders and a life policy is not a proper substitute for a 20 year endowment policy for other policyholders. These policies are policies of insurance which may meet particular needs or particular problems. As such they should not be barred.

If any criticisms are valid, they must fall in the area of the use made of the policy. This policy does not provide a maturity value at a discount. The maturity value is paid for by (1) a supplementary premium in the first year and (2) a charge included in the basic premiums in every year of the policy. If a company should use regular term rates during the renewal years, it would be logical to inquire as to the possibility of discrimination against the holders of other term policies.

The policy is a legitimate product as issued by companies which market it as a single contract without misrepresentation. It should be sold as a particular arrangement of benefits to achieve particular goals. In this way, abuses which there have alleged to take place, may be avoided. Companies should approach this by meticulous care in connection with its promotional material, instructions to agents and the specific wording used in the policy itself.

Summary

1. "Deposit Term" policies as currently issued do not provide for a "Deposit," an "accumulation at interest," a "fund" or a benefit independent of the basic coverage under the policy.

2. "Deposit Life" policies, as currently issued, do not include such elements either.

3. "Deposit Term" policies as currently issued are in fact partial endowments with high first year premiums. "Deposit Life" policies are merely variations of preliminary term policies or modified life policies with a high first year premium.

4. Maturity values, or initial values at the end of a term of years marked by a large increase in premium, are not accumulations of the "additional premium" in the first year at a rate of interest inconsistent with the rates assumed in calculating other benefits in the policy or the benefits in other policies.

5. There is probably little doubt that replacement of life and other policies by "deposit term" and "deposit life" policies could be reduced, and possibly eliminated, if the foregoing expressions and representations were unavailable for promotional purposes.

6. There is no forfeiture at any duration of the policy of any amounts in excess of that contemplated when the Standard Nonforfeiture Law was enacted. There is no evidence that the margins for initial expenses are excessive as compared to other policies.

7. Such policies containing cash values calcualted in accordance with the requirements of the Standard Nonforfeiture Law cannot be regarded as "unfairly discriminatory."

8. Adjustments to a basic formula, designed to fit a particular policy, by changing parameters or measures otherwise applicable to all policies has the inevitable result of encouraging the development of new contracts generally similar to but evasive of the special requirements.

Recommendations

1. The use of references to "Deposit," "Accumulation," "interest at x%" and all similar terms associated with fund accumulations and investment contracts should be banned as to use in policies, advertising and sales presentations in the case of any policy forms where all elements involve life contingencies. Such policies include so-called "Deposit Term" and "Deposit Life" policies.

2. That the insured under such policies is entitled to a cash value in excess of that produced by the formula applicable to all other policies is a mistaken notion and should not be made a basis for "corrective action."

3. A representation that an insured's premium payments, or any portion thereof, earn a higher return than under other forms of policies is a misrepresentation and should be prohibited.

4. Companies should carefully screen all promotional literature in the light of the actual form and structure of the policy. This would mean elimination of all references to "deposit," "accumulation" and "interest" as applied to the additional first year premium and maturity value. Further, no illustrations should show growth of a presumed "fund."

5. The criterion as to whether misrepresentation exists is to compare what can be said about a $1,000 policy with a $50 maturity value and a similar $1,000 policy with a $500 maturity value. If the same promotion with the corresponding numbers changed could not be used for both policies, close examination is probably in order.

6. The situation does not appear to warrant (1) a legislative approach (2) disapproval of policies that meet current legal requirements or (3) regulatory measures which would curtail the legal standards applicable to all policies.

7. No objection is seen to (1) regulations designed to promote the proper drafting of policy forms (2) close supervision over advertising and promotional materials associated therewith or (3) the issue of regulations that would limit practices that are found to be not in conformity with generally accepted marketing practices.

****

ATTACHMENT F-2

To: Mr. Ted Becker
Chairman, NAIC Technical Task Force
Texas Insurance Department

From: Burnet Halstead, Actuary
Kemper Life Insurance Companies
Long Grove, Illinois

Date: November 14, 1978

Re: Deposit Term

At the last meeting of the NAIC Technical Task Force the ACLI indicated they had changed their position regarding proposed nonforfeiture regulations from "one of active support to one of nonopposition." They also indicated that their legislative committee was reviewing the matter and they would be in a position to present their recommendations at your December meeting.

We have now received a draft dated October 2, entitled "Minimum Nonforfeiture Guideline Requirements for Approval of Partial-Endowment Type Products." It is the ACLI's intent to seek legislation now, in lieu of a regulation, to require essentially the same values they have proposed in the past. Apparently, they intend to present this at your December meeting.

We are convinced that the ACLI position (and the Unruh Committee position) represent solely the positions of large "establishment-type companies" who have a competitive problem. It doesn't represent a position that is in the interest of companies selling deposit term and more importantly, in our opinion, is not in the public's interest. These statements are made after observing the ACLI's Actuarial Committee and their Legislative Committee in action and after being consulted concerning deposit term by a member of the Unruh Committee at the time that report was being drafted.

The question undoubtedly has to be asked why the ACLI position is not in the public's interest since they are raising minimum nonforfeiture values on deposit term products. This would appear to be in the public's interest. Appearances, however, are sometimes deceiving. The reason it is not in the public's interest is that nonforfeiture values are raised so high that agents could not be paid sufficient commissions to make it worthwhile selling deposit term. This then in an indirect way denies the public of a product that is more competitive than whole life.

Deposit Term has been successfully sold in competition with conventional whole life products primarily because it generally costs less, pays lower dollar commissions, exposes less investment money to inflation and has more inherent flexibility. While commissions are lower than whole life commissions they are higher than traditional term commissions and enable an agent to make a living selling the product. Reducing these commissions, as the ACLI proposal would do, would make the product more competitive than it already is; but it would not be economically possible for an agent to sell it, especially in the middle income market where it is already impossible for agents to promote term insurance for the same reason.

In their October 2 draft the ACLI says "the intent of the law, as stated above, is that the excess initial expense allowance used to define minimum nonforfeiture values for partial endowment insurance shall not be based upon the 'additional first year premium' since an increase in the first year premium does not, in itself, increase the cost of protection or the cost of introducing or maintaining the insured as a policyholder." The ACLI is stating the intent of the law to suit the "establishment companies" that make up their committees. Alfred Guertin, who drafted the law in the first place is on record refuting this interpretation. (See attached).

The statement simply doesn't make any sense and in my opinion, insults the intelligence of the task force members. It would not appear that the premiums on any plan of insurance "in itself increases . . . the cost of introducing . . . the insured as a policyholder." The increased premium, just as in the case of the high first year premium on whole life insurance, does provide the money to pay a liveable first year commission to the agent; providing nonforfeiture benefits take into account a suitably amortized expense allowance. It should be remembered that nonforfeiture values should be premiums received less the cost of insurance less a reasonable expense allowance, less a reasonable profit or margin for contingencies. The cost of insurance is the same regardless of product. Why shouldn't the expense allowance be the same? Why should whole life companies be able to pay more money to producers than deposit term companies? Because "establishment companies" can then control the market. It seems to me, shameful that they would try to use regulatory bodies to stifle competition in this way.

We have written to the ACLI regarding the anti-trust implication of what they are trying to do. They do not appear to deny the implication is there but apparently feel as a trade organization they are immune to the law.

This material is critical of the ACLI proposal. On the other hand we do not feel that some change in the law would be inappropriate. If a change is made it should be applicable to all policies, not just to "deposit-term" policies. The substitution of a net level annual premium in place of the adjusted premium is, however, blatant discrimination against deposit term. A similar proposal on whole life would involve using the levelized net outlay (premium less increases in cash value) as a substitute for the whole life adjusted premiums. Clearly this would be as unacceptable to whole life companies as their proposal is to deposit term companies.

An acceptable alternative, in our view was sent in the following brief description dated September 6, 1978. A copy of that alternative is attached. It was never discussed in their Actuarial Committee.

Kemper Alternative to ACLI Guidelines

September 6, 1978

The intent of the Standard Nonforfeiture Law is to preserve equity between persisting and terminating policyholders. While this principle is simply enunciated, it is practically impossible to attain in operation. There are several primary causes and solutions for this:

(1) The level and incidence of expenses vary considerably from company to company. The Guertin Committee decided to define a minimum set of nonforfeiture values which would permit most companies to recover their acquisition expenses, permitting higher guaranteed values to be paid at the discretion of the company itself.

(2) True equity can only be determined retroactively and then only after the termination of the entire block of business. The individual company can dynamically estimate the emerging equities and recognize them through the dividend scale for participating business, or it can treat the actuarial gains and losses from lapsation as a risk assumed by the stockholder for nonparticipating business.

(3) Relatively higher first-year expenses generally result in negative early-year natural reserves thus, in equity, requiring the terminating policyholder to make a "termination payment" to the persisting policyholders. It is unlikely that such a system would gain a very wide popular following.

Certain forms have, however, been developed to cope with this aspect of the problem. These forms are characterized by a higher first-year premium than the premiums to be paid in some or all of the renewal years, thereby charging all of the initial policyholders the "termination payment" in advance. For those policyholders who terminate early the prepaid "termiantion payment" shall eventuate to be appropriate whereas for those policyholders who persist the unnecessary "termination payment" shall be reflected in either lowered renewal premiums or increased policy benefits than would otherwise be available.

As a rather recent innovation, products have been developed which guarantee the return of the "termination payment" at the end of a specified period of time, improved at that time in many instances with the equivalent of some rate of interest. These latter products are generally referred to as deposit term insurance, deposit whole life insurance or modified premium whole life insurance. The excess of the first-year premium over the renewal premium is not generally so large as the "termination payment" would theoretically be, but this pattern of premiums goes a long way toward meeting the initial objective of equity. Additionally, persistency studies have repeatedly demonstrated that "deposit term" type products, properly sold, result in significantly improved lapse rates over any other form of product. This latter feature of "deposit term" serves to minimize the residual inequity resulting from the above-mentioned inadequacy in the "termination payment."

Asset share studies demonstrate that for reasonable levels of acquisition expenses the Standard Nonforfeiture Law requires an appropriate level of early nonforfeiture values. However, because of then unforeseen product design, the law does not require a necessarily proper amortization of these acquisition expenses. Thus companies, in providing the return of the "termination payment" as an element of product design, have "gratuitously" offered a guaranteed nonforfeiture value well in excess of the minimum value required at that duration by the application of the current law. However, simply because a company is "gratuitous" at one duration there exists, under the Standard Nonforfeiture Law, no requirement that it be accordingly "gratuitous" at any other duration.

This oversight has led some people to declare the Standard Nonforfeiture Law to be inappropriate for "deposit term" type products and to propose a new standard for these forms. One such new standard would be to drastically reduce the acquisition expense allowance as well as to accelerate the amortization of that allowance. Should such a proposal be adopted, it would constitute a dangerous precedent: that a controversial product could be eviscerated by imposing upon that product a dramatically more demanding standard than that imposed on any other product.

The fundamental question remains one of equity. If a company is able to offer a "gratuitously" equitable nonforfeiture value at one duration, would it not be equitable for that company to offer a similarly "gratuitous" nonforfeiture value at a neighboring duration? In other words, were the company to equitably guarantee a tenth-year nonforfeiture value of $20.00 and were the premium due on the ninth anniversary to be $5.00, could the ninth-year nonforfeiture value equitably be zero? Truly equitable values would also need to be consistent. This "principle of consistency" should be applicable to all forms in all companies and would thus avoid the above-mentioned dangerous precedent.

A reasonable minimum test of consistency would seem to be that any nonforfeiture value available at the end of a policy year discounted for one year at the policy loan rate and further reduced by the gross premium due for that policy year should result in a value which is not greater than the nonforfeiture value available at the end of the preceding policy year. Thus in the preceding example, assuming a policy loan rate of 8%, the minimum consistent ninth-year nonforfeiture value would be $13.52.

$$\left(\frac{20.00}{1.08} - 5.00 = 13.52\right)$$

ATTACHMENT F-3

To: Mr. Ted Becker, Chairman
NAIC Technical Task Force
State Board of Insurance

From: George W. Harding, Actuary
University Life Insurance Company of America
Post Office Box 68192
Indianapolis, Indiana 46268

Date: November 15, 1978

This letter contains my thoughts and suggestions on three aspects of the deposit term subject:

1. Comments on the proposal by James Morton for a new method of determining cash values.

2. Concerns about the ACLI disclosure guideline.

3. Comments about modifying the package of NAIC amendments.

1. New Method of Determining Cash Values. It is not immediately apparent why this method is being proposed, nor does reflection yield any great insight. The principle is described as being similar to that used in defining minimum cash values for annuities, but the rationale of applying such a principle to life insurance escapes me. There is no indication that this method is more equitable than other methods nor that it produces more reasonable results. It certainly cannot be described as simpler; to the contrary, the calculations that would be required to develop the scale of cash values for all issue ages staggers the imagination!

Even if the rationale were accepted, this proposal would require legislative action. As I argue in item 3 below, I don't believe such action is warranted.

Even if legislative action were warranted, the proposal is discriminatory on 2 counts since it applies only to policies which provide for (a) scheduled decreases in premium during (b) the first 10 policy years. Evidently policies with either (a) increases in premium or (b) decreases after 10 years or (c) both, as well as policies with no change in premium, would be immune to this special treatment.

I suggest that this proposal be rejected.

2. The ACLI Disclosure Guideline. This document is the outgrowth of an evolutionary process which is now 2 or more years old. Although this "final" result is one which is reasonable in principle, there are certain aspects of it which concern me and which I request consideration be given for change.

   a. Item 1 of the Guideline makes it a misrepresentation to fail to fully and fairly inform the applicant in any advertisement, sales material or sales presentation. This would prohibit any sort of general advertising, flyer, direct mail or other sales piece which generally describes these policies. This is unreasonable and was not, I believe, intended; advertising for other types of policies are not restricted in this fashion, no matter how complicated they might be. I believe the intent was to require that statements be complete and accurate in the context in which they are used. I suggest that "adequately" be substituted for "fully and fairly."

   b. Item 5 of the Guideline imposes disclosure requirements if the policy contains a provision permitting voluntary deposits, whether or not the sales presentation anticipates the use of this provision. I believe the intent of this item was to eliminate confusion between the policy premiums and these voluntary deposits. If a sales presentation does not illustrate such deposits, there seems no need to impose special disclosure requirements. Further, the final phrase seems unnecessary. I suggest the following as a replacement for Item 5:

      > "If any sales material or presentation utilizes a policy provision which permits making voluntary deposits which accumulate at interest, the nature of the provision shall be disclosed and shall identify the insured's rights thereunder."

   c. Item 6 recommends that an explanation sheet be provided which shows 6 separate types of information for each of the first 20 years and also for certain other years. First of all, much of this information would also be required in the Policy Summary which must be provided under the NAIC Model Solicitation Regulation. To the extent that these two sets of requirements overlap, there will be unnecessary duplication. Further, there would be two sets of disclosure documents, a confusing rather than enlightening situation for the prospect. I suggest that a company be permitted to use the Policy Summary in place of the explanation sheet, where the Summary would otherwise be required. Secondly, the required 20 year illustration period is not necessary in order to show the premium and benefit patterns. I suggest that "each of the first 20 policy years and representative policy years thereafter" be changed to "each of the first five policy years, those subsequent years in which the premium changes and representative years thereafter." This wording will minimize the administrative burden without eliminating any meaningful information.

3. Modifying the NAIC 1976 Amendments Package. The Actuarial Committee of the ACLI has recommended that the package of amendments to the nonforfeiture and valuation laws be expanded so as to include requirement for nonforfeiture values per the ACLI Guideline. The Legislative Committee adopted this with the proviso that such inclusion not jeopardize passage of these amendments. I believe this recommendation to be unwise, for several reasons:

   a. The amendatory language is discriminatory because it applies only to deposit term. Any amendment recommended should apply generally, without singling out any class of policies. Even if the language were phrased so as to be nondiscriminatory, it would affect other types of policies unintentionally.

   b. There is no need to make any change. The current law defines values for deposit term policies. The study by Alfred Guertin states that the current law adequately handles deposit term plans.

   c. The proposed amendment would only apply in those states which have not yet passed the 1976 amendments. Thus, the Standard Nonforfeiture Law would be different in some states than others. The 1976 amendments would not otherwise affect a company, since they permit cash values, reserves and female values on a lower basis but do not require them. This amendment would require change rather than permit it.

d. The administrative burden would be immense. The proposed new expense allowance formula is not being enacted at the present time since a new mortality table is due in a very few years. It is planned that both changes be made at the same time, in order to save companies the expense and time of making one change now to effect the new expense formula and another change in just a few years to effect the new mortality table. The "deposit term amendments" would require values to be changed now and then again when the expense allowance formula and new mortality table are enacted. A burden which is felt to be unreasonable for most companies should likewise be regarded as unreasonable in the case of deposit term. The extent of this burden can be appreciated when it is realized that it would involve not only recalculation of cash values but reprinting and refiling of policy forms, reprinting rate book and sales material and updating all internal data files. This enormous burden would then be faced again in just a few years.

e. The result of the amendments for deposit term would be to raise the cost of insurance. The cash values required could not be provided within the current premium structure. Increased premiums will not only increase the direct premium cost to the insured but, in the event of early termination, will also increase the degree of forfeiture. Those persisting to the 10th year will also pay a higher cost for their benefits.

For these reasons, I strongly suggest that no attempt be made to include the "deposit term" amendments with the 1976 NAIC amendments.

****

ATTACHMENT F-4

To: Mr. John O. Montgomery, Deputy Insurance Commissioner
California Department of Insurance

From: E. James Morton, Executive Vice President
John Hancock Mutual Life Insurance Company
Boston, Massachusetts

Date: October 13, 1978

Re: Deposit Term Insurance

As you are aware, considerable controversy has surrounded the assertion that the current Standard Nonforfeiture Law did not contemplate Deposit Term or Deposit Whole Life products when it was proposed by the Guertin Committee back in the 1940's, and that the resulting minimum nonforfeiture values on such products are inequitable to terminating policyholders. An acceptable proposal to rectify this situation with regard to Deposit Term was developed by the Unruh Committee; however, a workable proposal with regard to Deposit Whole Life has thus far been lacking.

In this regard, we have recently heard from an Actuary from another insurer suggesting a possible solution to this problem. The proposal would calculate a "grid" of minimum nonforfeiture values by applying a method similar to the Annuity Reserve method which you were instrumental in developing. The minimum cash value at any duration would be the largest of all minimum values calculated for that duration. The method also defines the expense allowance in terms of a net level premium, as recommended in the Unruh Committee Report on Nonforfeiture Values.

While we at John Hancock have not had the opportunity to consider this proposal in any detail, it seems to merit serious consideration from the NAIC task force. Consequently, I am sending the attached material (including a description, examples, and proposed language) to you at this time because of your involvement in developing the Annuity Reserve method. While the Chicago meeting of the NAIC task force is probably too close to permit prior distribution to the other members, perhaps you will wish to mention this in open discussion.

I will be in Chicago for the Society meeting and perhaps can see you there.

Commissioners Annuity Reserve Approach for Minimum Nonforfeiture Values for
Policies with Premiums Which Decrease During the First Ten Years

Enclosed are several tables which illustrate the results under the current law and those under the proposal to apply the Commissioners Annuity Reserve Approach to Deposit Term and Deposit Whole Life.

The tables cover the following situations:

Table 1* 8 Year Deposit Whole Life – Age 35

Table 2* 8 Year Deposit Whole Life – Age 55

Table 3* 8 Year (YRT-type) Deposit Whole Life – Age 35

*Values are also applicable to a "pure" Deposit Term policy for durations 1-8.

The initial input for the proposed method are the minimum cash values calculated under the current nonforfeiture law. Then, a method analogous to the Commissioners Annuity Reserve Valuation Method is applied to the guaranteed value at each duration to generate additional "minimum" values, using an expense allowance based on the net level premium as recommended in the Society of Actuaries Report on Nonforfeiture Values. Then, actual minimum values at each duration are the greatest of the various values calculated at that duration.

A better understanding of the method as it applies to Deposit Whole Life can be gained by looking at the machine listing we can provide. Its values correspond to the plan shown in Table 1.

1. First, minimum cash values were calculated according to the current Nonforfeiture Law.

2. Then, minimum cash values were calcualted for a plan maturing for $1,000 at age 100 using an expense allowance based on the net level premium. (These values would appear on the horizontal lines corresponding to t = 65 (i.e., a 65 year plan). Vertical columns would represent duration from issue. These values can be compared by duration with the previously calculated values, with the minimum values being updated wherever the calculated value exceeds the minimum value as per 1.

3. Next, minimum values can be calculated (similarly as in 2.) for a plan to age 99 which matures for the largest value calculated for attained age 99; then for a plan to 98 maturing for the largest value for age 98, etc.

4. This process can continue until a 1 year term plan is considered. For this example, such 1 year term plan matures for zero – this is the largest of all prior values calculated for duration 1.

5. The minimum nonforfeiture values according to this proposal can be underlined in each column; negatives are, of course, taken to be zero. In this particular example, minimum values after the 16th year are identical to the current law minimums. However, prior to the 17th year, the proposed minimums are larger.

Examples of Minimum Nonforfeiture Values Required
Under the Proposed Amendment to the Standard Nonforfeiture Law

Deposit Whole Life – Modified Eight Year Whole Life
(Using Current Law as Minimum)

Insurance Benefit During Modified Period	$1,015.00
Insurance Benefit Following Modified Period	1,000.00
Pure Endowment at End of Modified Period	15.00
Annual Gross Premium During Modified Period	4.49
Additional First Year Premium (Deposit)	7.50
Annual Gross Premium Following Modified Period	25.00
Net Level Premium During Modified Period	4.63

1958 CSO 4%

Age Nearest Birthday Curtate

Issue Age 35

Duration	Minimum Under Proposed Law	Minimum Under Current Law
0	-21.57	-26.92
1	- 4.75	-19.56
2	- 3.68	-18.94
3	- 1.25	-18.45
4	2.16	-18.17
5	5.54	-18.12
6	8.83	-18.36
7	11.99	-18.93
8	15.00	-19.86
9	-15.41	-17.85
10	1.18	- 0.47
11	18.36	17.27
12	36.04	35.36
13	54.17	53.77
14	72.70	72.50
15	91.59	91.51
16	110.81	110.79
17	130.32	130.32
18	150.08	150.08
19	170.07	170.07
20	190.25	190.25
25	293.27	293.27
30	396.83	396.83
35	495.83	495.83
40	586.12	586.12
45	669.36	669.36
50	739.07	739.07
55	800.16	800.16
60	865.68	865.68
65	1,000.00	1,000.00

Deposit Whole Life – Modified Eight Year Whole Life
(Using Current Law as Minimum)

Insurance Benefit During Modified Period	$1,027.00
Insurance Benefit Following Modified Period	1,000.00
Pure Endowment at End of Modified Period	27.00
Annual Gross Premium During Modified Period	20.72
Additional First Year Premium (Deposit)	13.50
Annual Gross Premium Following Modified Period	74.16
Net Level Premium During Modified Period	20.89

1958 CSO 4%

Age Nearest Birthday – Curtate

Issue Age 55

Duration	Minimum Under Proposed Law	Minimum Under Current Law
0	-28.12	-38.80
1	- 6.69	-24.14
2	.81	-21.92
3	8.08	-20.99
4	14.57	-21.56
5	19.98	-23.86
6	24.06	-28.19
7	26.51	-34.84
8	27.00	-44.18
9	-33.35	-36.82
10	- 1.47	- 2.66
11	31.71	31.23
12	64.86	64.75
13	97.77	97.77
14	130.18	130.18
15	161.92	161.92
16	192.97	192.97
17	223.39	223.39
18	253.29	253.29
19	282.81	282.81
20	312.01	312.01
25	450.38	450.38
30	566.26	566.26
35	667.80	667.80
40	776.72	776.72
45	1,000.00	1,000.00

Deposit Whole Life – Modified Eight Year Whole Life
(Using Current Law as Minimum)

Insurance Benefit During Modified Period	$1,015.00
Insurance Benefit Following Modified Period	1,000.00
Pure Endowment at End of Modified Period	15.00
Annual Gross Premium During Modified Period	1YT*
Additional First Year Premium (Deposit)	7.50
Annual Gross Premium Following Modified Period	25.00
Net Level Premium During Modified Period	4.63

Duration	Minimum Under Proposed Law	Minimum Under Current Law	* One Year Term Premiums
0	-21.57	-26.29	3.33
1	- 3.96	-16.81	3.48
2	- 3.36	-13.62	3.66
3	- 2.99	- 9.79	3.91
4	- .69	- 5.20	4.19
5	2.55	- 8.73	4.50
6	6.20	-12.71	4.86
7	10.33	-17.18	5.24
8	15.00	-22.19	
9	-17.08	-20.14	
10	- 1.49	- 2.72	
11	15.77	15.06	
12	33.56	33.19	
13	51.80	51.64	
14	70.45	70.41	
15	89.47	89.47	
16	108.79	108.79	
17	128.36	128.36	
18	148.17	148.17	
19	168.20	168.20	
20	188.43	188.43	
25	291.68	291.68	
30	395.47	395.47	
35	494.70	494.70	
40	585.19	585.19	
45	668.62	668.62	
50	738.49	738.49	
55	799.71	799.71	
60	865.38	865.38	
65	1,000.00	1,000,00	

Proposed **Amendment** To Section 5 of the Standard Nonforfeiture Law
To Apply the Commissioners Annuity Reserve Approach for Minimum Nonforfeiture Values
To Policies With Premiums Which Decrease During the First Ten Years

In the case of policies which provide for a scheduled decrease or decreases in premiums at any time during the first ten policy years, any cash surrender value available under the policy in the event of default in a premium payment due on any policy anniversary, whether or not required by section two, shall be an amount not less than the greatest of the respective excesses, if any, of the present values, on such anniversary, of the future guaranteed benefits, including any existing paid up additions, which would have been provided for by the policy up to the end of each respective policy year and including any pure endowment or cash surrender value available at the end of such respective policy year if there had been no default, over the sum of (a) the then present value of the adjusted premiums as defined in this paragraph corresponding to premiums which would have fallen due on and after such anniversary and prior to the end of such respective policy year, and (b) the amount of any indebtedness to the company on the policy. For purposes of this paragraph, the adjusted premiums used in computing any respective excess as defined in this paragraph shall be calculated on an annual basis and shall be such uniform percentage of the respective premiums specified in the policy for each policy year which are due prior to the end of the respective policy year used in defining such respective excess, excluding amounts stated in the policy as extra premiums to cover impairments or special hazards, that the present value, at the date of issue of the policy, of all such adjusted premiums shall be equal to the sum of (i) the then present value of the future guaranteed benefits provided for by the policy up to the end of the resepctive policy year used in defining such respective excess, including any pure endowment or cash surrender value available at the end of such respective policy year; (ii) two percent of the amount of insurance, if the insurance be uniform in amount, or of the average amount of insurance at the beginning of each policy year up to the earlier of such respective policy year or the tenth policy year; (iii) forty percent of the nonforfeiture net level premium as defined in this paragraph; (iv) twenty-five percent of either the nonforfeiture net level premium or the adjusted premium for a whole life policy of the same uniform or average amount with uniform premiums for the whole life issued at the same age for the same amount of insurance, whichever is less. Provided, however, that in applying the

percentages specified in (iii) and (iv) of this paragraph, no adjusted or nonforfeiture net level premium shall be deemed to exceed four percent (4%) of the amount of insurance or of the average amount of insurance as defined in (ii) of this paragraph. The nonforfeiture net level premium used in the computation of any respective excess as defined in this paragraph shall be equal to the present value, at the date of issue of the policy, of the guaranteed benefits provided for by the policy up to the end of the respective policy year used in defining such respective excess, including any pure endowment or cash surrender value available at the end of such respective policy year, divided by the present value, at the date of issue of the policy, of an annuity of one per annum payable on the date of issue of the policy and on each anniversary of such policy on which a premium falls due prior to the end of such respective policy year.

****

ATTACHMENT G

From: John Montgomery
California Department of Insurance

Date: September 15, 1978

Re: California Actuarial Guidelines for Reserving & Computing Nonforfeiture Values

The second exposure draft of "Interpretations of the California Insurance Code with Respect to Valuation and Nonforfeiture Value Requirements Applicable to Life Insurance and Annuity Products" is attached. The first appears on p. 452 of the 1978 Proceedings V. II.

Changes from the first draft are:

Guideline 3 concerning the valuation of supplementary contracts has been rewritten.

Another sentence has been added to Guideline 6 with respect to functions permissible for minimum standards.

Guideline 7, joint life values, has been reworded slightly.

Guideline 8, additional reserves for convertibility and renewability, has been removed. More consideration needs to be given to the drafting of this guideline than is possible at this time.

Guidelines 9, 10 and 11 have been combined and rewritten, now appearing as guideline 8, distinguishing the valuation of basic policy benefits from the valuation of riders attached to policies.

Guideline 12 has been renumbered as guideline 9 concerning pure endowments and Equivalent Level Amounts.

Guideline 13 on the valuation of renewable term plans and of policies converted from term insurance has been deleted. The department is considering the adoption of the NAIC guideline which would then replace the existing practice in California as exemplified by Bulletin 74-11.

Guideline 14 has been rewritten and now appears as guideline 10.

Guideline 15 has been slightly reworded and now appears as guideline 11.

Guideline 16 has been rewritten and now appears as guideline 12.

Second Exposure Draft, September 1978

Interpretations of the California Insurance Code
With Respect to Valuation and Nonforfeiture Requirements
Applicable to Life and Annuity Products

This is to clarify the position of the California Insurance Department with respect to the interpretation of the California Insurance Code concerning valuation and nonforfeiture requirements applicable to life and annuity products. It is

contended that the interpretations contained herein do not represent any change from those previously rendered unless the interpretation is specifically identified as a change in Insurance Department practice. These interpretations are intended as a reference for use either by insurers writing business in the State of California or by Insurance Department examiners examining such insurers.

1. Valuation and nonforfeiture provisions of the California Insurance Code are to be applied to group permanent plans in the same manner as to individual plans. However mortality tables allowed for group plans may be used for group permanent.

2. Annuity reserve requirements apply also to individual insurance funds on deposit such as premium deposit funds, advance premium deposits or any deposits regardless of title.

3. Reserve requirements applicable to Single Premium immediate annuities issued at the time a supplementary contract is initiated apply to such supplementary contracts either with or without life contingencies. For the supplementary contracts without life contingencies it is obvious that only the valuation interest rate would be applicable.

4. For reserves and values using continuous functions:

   (a) $\bar{D}_x = {}_0\int^1 D_{x+t}\, dt$

   By assuming that D_{x+t} is linear for $0 \leq t \leq 1$

   $\bar{D}_x \doteq 1/2\,(D_x + D_{x+1})$

   By assuming that the deaths in the year of age x to x+1 are uniformly distributed over that year of age

   $\bar{D}_x = [(\delta - d)/\delta^2]\, D_x + [(i - \delta)/\delta^2]\, D_{x+1}$

   where: $d = iv = i/(1+i)$
   δ = force of interest
   i = interest rate

   (b) $C_x = {}_0\int^1 D_{x+t}\, \mu_{x+t}\, dt$

   By assuming that deaths in the year of age x to x+1 are uniformly distributed over that year of age

   $C_x = (i/\delta)\, C_x$

   By assuming that the total deaths are concentrated at the middle of the year of age,

   $C_x = (1+i)^{1/2} C_x$ or $(1+i/2)C_x$

5. The use of age-nearest-birthdate or age-last-birthdate mortality assumptions is permitted in the determination of minimum reserves or minimum nonforfeiture value depending upon the assumptions used in calculating the premiums for the plan so valued. Subsection (f) of Section 10160 of the California Insurance Code states:

   > (f) A brief and general statement of the method to be used in calculating the cash surrender value and the paid-up nonforfeiture benefit available under the policy on any policy anniversary beyond the last anniversary for which such values and benefits are consecutively shown in the policy with an explanation of the manner in which the cash surrender values and the paid-up nonforfeiture benefits are altered by the existence of any paid-up additions credited to the policy or any indebtedness to the insurer on account of or secured by the policy.

   The brief and general statement should include the nonforfeiture factors needed to determine the values beyond the last anniversary for which values are shown in the contract.

6. Only curtate functions are permissible in the determination of minimum nonforfeiture values, while for the determination of minimum policy reserves either curtate or continuous functions are permissible. This does not prohibit the use of continuous functions in the determination of nonforfeiture values provided such values equal or exceed the minimum.

7. Reserves and nonforfeiture values for joint life insurance benefits may be calculated by treating the joint life table as a single life table and applying the Standard Laws accordingly.

8. All benefits incorporated in a policy must be reserved, while benefits attached to policies as optional riders must be reserved separately with respect to each rider. A policy may not be split into a policy and a rider, or riders, for the purpose of circumventing the requirements of the standard valuation or nonforfeiture value laws.

9. Pure endowments will not be considered in the determination of Equivalent Level amounts for valuation and nonforfeiture purposes.

10. For the calculation of premium deficiency reserves or reserves for interest guarantees in excess of the maximum permissible valuation interest rate, reserve sufficiencies may not be offset against prior deficiencies.

11. Individual Single premium deferred annuity reserves shall at least equal the greatest of any of the discounted values of cash surrender values available after the date of valuation, such cash values discounted to the valuation date at the maximum permissible statutory interest rate.

12. Individual flexible premium annuities shall be valued only as to the accumulation of paid premiums without assumption as to the amounts of future payments and shall be valued otherwise according to the same valuation standards as are applicable to annual premium deferred annuities.

****

ATTACHMENT H

To: NAIC Technical Task Force to Review Valuation and Nonforfeiture Values

From: Jerome S. Golden, Chairman
Variable Products Technical Advisory Committee

Date: October 25, 1978

Re: Variable Annuity Nonforfeiture Regulation

The variable annuity nonforfeiture regulation developed by the Variable Products Technical Advisory Committee was received by the Technical Task Force at its December 1977 meeting. At the April 1978 meeting in Tampa, Harold Leff of the Metropolitan raised the following points concerning the regulation:

1. The expense allowances do not make projection for future inflation;

2. There is no provision for charges on transfers between fixed and variable accounts; and

3. The right to cancel small annuities is based on total prior contributions, and does not reflect the effect of partial withdrawals.

The advisory group has discussed these issues internally and with Mr. Leff, and have the following recommendations:

1. In Section 4, paragraph 2, delete the following phrase in the third line: "allocated to the account or accounts funding the contract." This change would clear up some possibly ambiguous wording in the regulation. It is intended to make clear that in demonstrating that the contractual nonforfeiture amounts equal or exceed the minimum nonforfeiture amounts, an insurer may use the percentages of net considerations based on the limits specified in Section 5 (in determining minimum nonforfeiture amount) even if such percentages of net considerations are lower than the actual amounts allocated to the account under the contract.

2. In Section 9(b), add the following phrase after the word "period" in the fourth line: ", reduced to reflect any partial withdrawals from or partial surrenders of the contract,". This change will recognize that contract values may be reduced because of partial withdrawals or partial surrenders. We rejected the concept of using the account value since that value might decrease because of poor separate account investment experience, and we felt that contracts should not be cancelled on this basis.

On the general question of provision for inflation in the per contract or per transaction charges, we have not reached agreement. Here are a few points that should be considered:

1. Although variable annuity contracts do not provide for interest margins per se, they generally do provide for asset charges which could be available to offset inflating expenses. Unlike interest margins in a fixed annuity, these asset charges are guaranteed to be earned in every contract year, although they are generally relatively modest.

2. The percentage loadings permitted by the regulation do provide margins relative to actual percentage loadings currently being charged, and are, thus, available as an offset to contract charges that are higher than permitted in the regulation.

3. The use of flat dollar charges which clearly will be out of date at some point in the future will make the demonstration of compliance with the regulation quite complex.

4. One suggestion offered would be to have a time limit on the applicability of the current limit on contract charges and to have them reviewed by, say, a standing committee of NAIC or this task force.

We are seeking the task force's direction in this area.

****

ATTACHMENT I

To: Mr. Ted Becker, Actuary
Texas Insurance Department

From: James R. Carlisle, Chief Examiner
State of Alabama Department of Insurance

Date: August 21, 1978

Re: Reserving for an Interest Deficiency by Life, Credit, and A & H Insurers

This department is studying ways to strengthen its insurance laws and surveillance methods. One real problem in Alabama is life companies investing in low income producing assets such as real estate; the cause of which is twofold: (1) Alabama operated without an investment law until January 1, 1978 and (2) Companies made use of this loophole by investing in real estate or other nonincome producing assets where the admitted value was fairly easy to inflate thus gaining additional surplus.

The newly enacted investment law prohibits any further investments with the exception of 10% in real estate. It is my opinion then that in years to come the problem will be eliminated. However, there are other factors which will cause the workout to take many years.

For several years I have contended that life companies with considerable nonincome producing assets are creating an additional liability each year they fail to earn the interest requirements of reserves. In an earlier letter to Mr. Tom Pennington of Protective Life Insurance Company, Birmingham, I discussed the possibility of requiring a company to post as a liability each year for the amount that net investment fails to equal the tabular interest cost with a provision to reduce this liability by any excess earnings in a particular year, and a further provision to compound this liability each year by the average interest rate on reserves. Mr. Pennington's response is attached.

Alabama law presently allows additional reserves "as last adopted or approved by the National Association of Insurance Commissioners." To have the legislature amend this law specifically is a very long and often times futile process. Therefore, the question has arisen "Has NAIC ever considered or would it consider adopting a reserve requirement based upon interest earnings?"

I first contacted Mr. Christy Armstrong, Chief Examiner of the California Insurance Department and later talked with Mr. Tom McFarling of your department. It was Mr. Armstrong who suggested I contact you.

I would appreciate receiving your ideas on Mr. Pennington's letter and any other suggestions you have. If you should consider any action at an NAIC meeting I would appreciate advance notice so that Mr. Pennington or our consulting actuaries could prepare whatever necessary. Your cooperation with this department is appreciated.

****

To: Mr. James R. Carlisle
Chief Examiner
Alabama Insurance Department

From: Thomas E. Pennington
Senior Vice President & Actuary
Protective Life Insurance Company
P.O. Box 2606
Birmingham, Alabama 35202

Date: August 1, 1978

Re: Reserves for an Interest Deficiency by Life, Credit, and A & H Insurers

It goes without saying that I will be glad to consult with the department on issues such as this at any time it would be of any help to the department.

I think the group has put its finger on a major problem in insurance companies insolvencies. One of the major contributing factors to the slow workout of the Empire Fund has been our problems in getting many of the nonrevenue producing assets replaced with productive assets, while faced with the shortfalls in interest requirements while this is being done.

I do, however, believe that a reserve for interest deficiencies should always be prospective in nature. The shortfall that occurred in the current statement year has already been charged against earnings. The real problem is the inadequacy of the reserves computed at a fictitiously high rate compared to the actual earned interest.

Since recomputation of reserves at a lower rate is a complex job requiring more sophisticated actuarial talent than many of the companies would have available and since on many examinations it would be desirable if the examiner could determine at least if the problem existed, I have attempted in the enclosed note to set forth a procedure to be followed and an approximation method utilizing the "rule-of-ten" to determine a reasonable reserve for interest deficiency without the need for substantial revaluation.

As you will see in the note, in addition to relying on the required interest shown on page 6, I have also suggested that if the Exhibit 9 reserves requiring interest are substantial or if there are funds on deposit reflected in other lines of the statement which require interest and which are not in Exhibits 8 or 10, that these also be taken into account in determining the interest deficiency. A company heavily committed to accident and health or a company which has accumulated substantial deposits whether for pension plans, advanced premium deposits, side funds or otherwise, could apparently have adequate interest income on Page 6 but still be woefully deficient.

Note on the Determination of Reserves for an Interest Deficiency

I. To determine whether this reserve is required, the following values should be determined:

1. Required interest as shown on Page 6, Column 1, Line 5 (tabular).

2. If there are reserves included in Exhibit 9 which are computed assuming an interest rate discount, then the total amount of such reserves should be determined as of the end of the statement year. If such amount exceeds 10% of Page 6, Column 1, Line 15, then compute the following items:

   a = amount of Exhibit 9 reserves computed requiring interest December 31 prior year. (A & H)

   b = amount of Exhibit 9 reserves computed requiring interest December 31 current year. (A & H)

   l = required interest computed according to the formula described for Type 1 items in the Page 6 instructions.

3. If there are other reserves reflected on Page 3 of the statement but not included in Exhibits 8, 9 and 10 which represent funds deposited at interest or a future benefit discounted for interest, the required interest for such funds earning interest or discounted for interest should be determined. If there is total required interest for such funds exceeding 5% of the earned interest as reflected on Page 5, Column 1, Line 4 then compute the following values:

   c = interest requiring funds December 31 prior year. (side funds)

   d = interest requiring funds December 31 current year. (annuities, etc.)

   m = required interest for such reserves utilizing the Type 2, Page 6 formula.

   It should be noted that examples of such items would include premium deposit funds, funds on deposit, side fund deposits, and discounted employment contracts, as well as any other item for which the liability assumes either an interest discount or which themselves bear an interest rate payable to outside parties.

4. Determine the total required interest (I) equal to the amount reflected on Page 6, Column 1, Line 5 plus l plus m. If the total required interest is greater than the earned interest (J) which is the amount reflected on Page 5, Column 1, Line 4, then a Reserve for Interest Deficiency is required. This reserve may be calculated under either of the two following ways. (Life, A & H, and side funds)

II. Approximate method of calculating the Reserve for Interest Deficiency.

1. Determine the following values:

   A = the amount reflected on Page 6, Column 1, Line 1 plus a plus c. (prior)

   B = the amount reflected on Page 6, Column 1, Line 15 plus b plus d. (current)

As you will note, this is a significant reserve. It probably is less than would be produced under an exact revaluation method, but still is material enough to make some provision for the effect of the shortfall in interest from invested assets. In point of fact, it would probably serve as an effective deterent to wasteful investment of company assets in nonrevenue producing investments.