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Joseph M. Belth, Editor
Ann I. Belth, Business Manager
Jeffrey E. Belth, Circulation Manager

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SECONDARY GUARANTEES, MARKETERS, ACTUARIES, REGULATORS, AND A POTENTIAL FINANCIAL DISASTER FOR THE LIFE INSURANCE BUSINESS

The primary guarantees in a life insurance policy are the insurer's promises to pay the death benefit upon the death of the insured or the cash value upon surrender of the policy. Many universal life policies today are being sold with a so-called secondary guarantee—a promise to continue the protection for the life of the insured irrespective of the size of the account value, provided that certain scheduled level premiums are paid. The scheduled level premiums often are far below the level premiums for otherwise comparable traditional whole life policies.

The reserves established for universal life policies with secondary guarantees appear small and the scheduled level premiums appear inadequate. A life insurance policy is a long-term instrument—many policies remain in force more than 50 years—and the impact of small reserves and inadequate premiums sometimes is not felt for many years.

Marketers, anxious to increase new business and generate large sales commissions, press insurers to issue policies with low premiums. Actuaries figure out how to minimize reserves and justify low premiums. Regulators allow the policies to be sold. The individuals in those groups share responsibility for the current widespread use of policies with small reserves and inadequate premiums. Those individuals will no longer be associated with the life insurance business when the devastating financial consequences of the policies now being foisted on the public will have to be confronted by subsequent generations of marketers, actuaries, and regulators.

The Role of Reserves

Reserves are liabilities. They typically dominate the liability side of a life insurer's balance sheet. On the asset side of the balance sheet are government and corporate bonds, mortgages, stocks, real estate, bank accounts, and other investments. To be solvent, a life insurer must have assets greater than its liabilities. When its liabilities are greater than its assets, the insurer is insolvent.

A life insurer must charge premiums sufficient to generate assets exceeding its liabilities. An insurer that charges premiums insufficient to generate assets exceeding its liabilities may be able to rectify the problem temporarily, but not permanently, through infusions from investors, reinsurance arrangements, and other devices. Thus large (conservatively calculated) reserves force an insurer to charge adequate premiums, while small (aggressively calculated) reserves allow an insurer to charge inadequate premiums.

Life insurance premiums are not regulated directly. In terms of maximum premiums, there is neither

CONTENTS OF THIS ISSUE

Item	Page
Secondary Guarantees, Marketers, Actuaries, Regulators, and a Potential Financial Disaster for the Life Insurance Business	21
Lesson: Nonforfeiture Benefits	23
Lesson: The Tontine Concept	24
Lesson: Term to 100 in Canada	28
Conseco Adds to the Confusion Surrounding RBC Ratios	31
Conseco's Combined RBC Ratios	36
My Questions and Conseco's Answers	37
TIAA's Surprising Exit from the Long-Term Care Insurance Business	41
Statement of Joseph M. Belth on TIAA Transfer to MetLife	42
From the Mailbag	44

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direct nor indirect regulation; the forces of competition are the public's only protection against excessive premiums. In terms of minimum premiums, there is indirect regulation that takes the form of reserve requirements. (There is some maximum premium regulation in credit life insurance, but that topic is beyond the scope of this discussion.)

The Nature of Reserves

The reserve for a block of in-force life insurance policies is an estimate of the insufficiency of future premiums. Consider a block of level-premium policies issued 20 years ago. Because of relatively low death rates during the first 20 policy years, the premiums paid during those years are more than sufficient to pay the death benefits incurred during those years. However, because of relatively high death rates in the later policy years, the premiums paid during those years are not sufficient to pay the death benefits incurred during those years. The reserve at the end of the first 20 years is an estimate of that insufficiency. Stated another way, the reserve at the end of the first 20 years is the present expected value of future benefits minus the present expected value of future premiums.

The Role of the Actuary

The most important role for the actuary of a life insurer is the calculation of reserves. He or she chooses the method to be used in calculating reserves and the assumptions to be made in the calculations. Although restrictions on methods and assumptions are imposed by statutes, regulations, and professional guidelines, the actuary has great latitude in calculating reserves. The actuary also calculates premiums.

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The Conflict of Interest

The actuary has a conflict of interest. The fundamental question is whether the actuary's primary obligation is to the chief executive officer of the life insurer that pays the actuary, or whether the actuary's primary obligation is to the public interest and the long-term survival of the insurer. I think the actuary's primary obligation is to the public interest and the long-term survival of the insurer.

Consider an actuary who is an employee of a life insurer. The chief marketing officer persuades the chief executive officer that a certain type of policy is needed for sales purposes. The actuary chooses a conservative reserve method and conservative assumptions, and calculates adequate premiums. However, the chief marketing officer persuades the chief executive officer that lower premiums are needed for sales purposes. If the actuary refuses to change the numbers, he or she may be fired. So the actuary chooses an aggressive reserve method and aggressive assumptions, and calculates inadequate premiums that are acceptable to the chief marketing officer.

Next, consider a consulting actuary who is not an employee of any one life insurer. The chief marketing officer of a particular insurer persuades the chief executive officer that a certain type of policy is needed for sales purposes. A consulting actuary who refuses to design the kind of policy and premium level desired by the chief marketing officer will not be retained by the insurer. Rather, the insurer will retain a consulting actuary who is willing to design the desired type of policy and premium level. Indeed, a consulting actuary may initiate the process and seek to be retained by the insurer. Thus the consulting actuary may design a policy using an aggressive reserve method and aggressive assumptions, and calculate inadequate premiums that are acceptable to the chief marketing officer.

Actuaries who work for regulators may not be in a position to do much about the problem. Most state insurance departments do not have the financial resources to confront the companies on reserve issues; some departments do not even employ a full-time actuary. When regulators modify the rules to address reserve issues—sometimes after years of effort—the insurers can devise methods for circumventing the new rules before the ink is dry on the new rules.

The Secondary Guarantees

The secondary guarantees—often called "no-lapse guarantees"—that are discussed in this article have been a subject of debate among actuaries for years. Actuaries working for insurers actively selling large numbers of policies with no-lapse guarantees are on one side, and actuaries working for insurers that do not sell such policies are on the other side.

Consider, for example, the debate over whether an insurer issuing insurance with a no-lapse guarantee

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should be required to offer a nonforfeiture benefit relating to the guarantee. Insurers that sell large numbers of policies with no-lapse guarantees argue that such a requirement is "unnecessary, disruptive, and not in the best interest of consumers who will have to pay higher premiums for a potential additional nonforfeiture benefit that they neither want nor need," that "universal life insurance is not whole life and is not term, and regulations that work for those products simply don't fit universal life," and that the requirement "would put a significant strain on administrative system resources and budgets with little or no benefit to consumers." Meanwhile, insurers that do not sell such policies argue that a nonforfeiture benefit relating to no-lapse guarantees is necessary to create a "level playing field" for universal life and traditional products, that requiring a nonforfeiture benefit is "good public policy," and that insurers offering no-lapse guarantees should not be allowed to "circumvent minimum cash value consumer protections."

Other Controversies

The current debate over the implications of no-lapse guarantees is nothing new for the life insurance business. There have been numerous controversies over the years. In most of them, the argument is between aggressive marketers who take a short-term view of the life insurance business and conservative traditionalists who take a long-term view. I am in the latter camp, because I think life insurance is a long-term financial instrument that requires a long-term perspective.

The debates carried on by aggressive marketers and conservative traditionalists often end only after scandals confirm the need for a long-term perspective. In that regard, some important lessons may be learned from the history of the life insurance business. Three of those lessons are the subjects of articles in this issue: the establishment of nonforfeiture benefits in the United States, as discussed beginning below; the war over the tontine concept, as discussed beginning on page 24; and the Canadian experience in the marketing of level-premium term life insurance to age 100, as discussed beginning on page 28.

There are many other lessons, some of which have been subjects of articles in *The Insurance Forum*: the establishment of strong reserve requirements in the United States during the 19th century and the weakening of those requirements during the early years of the 20th century; the use of investment-year methods in the calculation of dividends on participating life insurance policies, as discussed in our April 1976 issue and other issues; the problems associated with the marketing of universal life insurance, as discussed in our October 1985 issue and other issues; the marketing of life insurance through so-called minimum deposit arrangements, as discussed in our April 1988 issue; the saga of Executive Life Insurance Company, as discussed in our October 1988 issue and other issues; the collapse of Mid-Continent Life Insurance Company, as discussed in our August 1997 issue; the problems associated with viatical transactions, as discussed in our March 1999 issue and other issues; the marketing of variable life insurance and the so-called surrender squeeze, as discussed in our December 2000 issue; the problems associated with the death benefits in variable annuities during the recent downturn in the stock market; the use of the so-called R-factor in the marketing of universal life insurance, as discussed in our December 2003 issue; and long-term care insurance, one aspect of which is discussed on page 41 and in the statement beginning on page 42.

LESSON: NONFORFEITURE BENEFITS

As early as the 1830s, long before the Civil War in the United States, Elizur Wright of Boston was recognized as an outspoken critic of slavery and an ardent abolitionist. He was also a mathematician, and he was fascinated by the beginnings of life insurance in this country. In his later years, he had a greater impact on the development of the life insurance business in the United States than any other person. That is why he is called "the father of life insurance."

The 1844 Trip to England

A newly organized American life insurer commissioned Mr. Wright to travel to England in 1844 to study and report back on the operation of the well-established life insurance business there. His experiences on that trip altered the course of his life, and his efforts revolutionized the life insurance business in the United States.

During his visit to London, Mr. Wright happened to attend a literary breakfast. When someone asked him about the purpose of his visit, he mentioned his keen interest in the life insurance business. At that point a prominent songwriter expressed dismay and called life insurance "the greatest humbug in Christendom." Mr. Wright described himself as "thunderstruck" by the comment, and said he would not have dared to make the dangerous ocean voyage if he had not purchased life insurance to protect his wife and five children who remained at home in Boston.

The songwriter told Mr. Wright to "Go to the Royal Exchange Thursday afternoon at three o'clock, and you will see what I mean." Mr. Wright did so, and he saw policies on the lives of elderly men being auctioned off to speculators "to be kept up by them by their paying annual premiums to the company till the decease." Each policy was a long-term, level-

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premium policy that did not provide for any payment to the policyholder upon discontinuation of the policy.

Mr. Wright viewed the absence of any payment to the policyholder upon discontinuation of the policy as an unwillingness on the part of the life insurer to buy back its policy, and the presence [illegible] such a payment as a willingness on the part of the insurer to buy back the policy for a purchase price equal to the [illegible] of the payment. As he described the situation, elderly policyholders who needed or wanted money when they discontinued their policies were forced to sell the policies to speculators "because the companies made it a rule never to buy their own policies."

Mr. Wright disliked that rule intensely. He had seen slave auctions at home, and he found similarly distasteful the sale of a life insurance policy at an auction such as he had witnessed. He said that if he should become old, he "should not like to have a policy on my life in the hands of a [illegible] the slightest pecuniary motive [illegible]

The Concept of Forfeiture

Aside from the danger and indig[illegible] by the insured in the type [illegible] Mr. Wright had witnessed, he viewed the sale of a long-term, level-premium life insurance policy without provision for any payment upon discontinuation of the policy as inherently unfair to the policyholder. He knew that the level prem[illegible]id in the early years of such a policy exceeded th[illegible]ounts needed to pay the death benefits in the early [illegible] needed to pay [illegible] benefits in the later years exceeded the premiums [illegible] later years, and that the premium overpayments [illegible]eated an "equity." He thought it was morally wrong [illegible] life insurer to force a "forfeiture" of that equity when the policyholder discontinued the policy.

When Mr. Wright returned from his trip to England, he lobbied for the creation of an insurance regulatory agency. His efforts resulted in the establishment of an agency in Massachusetts, and he was appointed the first state insurance commissioner.

Mr. Wright fought for enactment of "nonforfeiture laws" prohibiting the sale of long-term, level-premium life insurance policies without "nonforfeiture [illegible] Nonforfeiture benefits initially were limited to paid-up life insurance, but later came to include cash values. [illegible]

ABOUT THIS REPRINT

This is [illegible] reprint of the first two articles (the first 3½ pages) from the [illegible]