

Break-Even Formula

At the recent annual meeting of the Society of Actuaries, a summary of research was presented that indicated that the purchase price of life insurance policies in the secondary market, so-called life settlements, is often less than one-half the intrinsic economic value of the policies at the time of purchase. Defenders of this still new and evolving activity will undoubtedly challenge the assumptions made by the researcher in his analysis, which may present a more negative picture than the true facts justify.

Unlike some others, I am not philosophically opposed to life settlements. They do provide the owner of a no-longer-needed-or-desired policy an additional option for disposing of the contract. I do believe, however, that policy-owners should be provided with adequate disclosure so they can make a reasonably informed decision about what is in their best interest. I would like to propose one element of such adequate disclosure. I will call it the “break even” test. To illustrate it, I will assume the following:

- Nonpar whole life policy with face amount of \$1 million;
- Annual premium of \$15,000, prorated in year of death;
- Life settlement purchase price offer of \$300,000;
- Risk-free interest rate of 5 percent.

The break-even formula is:

$$\$300,000 = \$1,000,000v^n - \$15,000a_{\overline{n}|i}$$
 Solve for n , which is the number of years that, if the insured outlives it, makes the policy-owner a winner and, if not, a loser. In this case, n is approximately 15.6 years. The policy-owner can then self-assess, perhaps with the advice of his or her physician, whether the offer is good, taking into consideration other relevant factors besides the insured’s likely remaining lifetime.

The proposed formula would, of course, need modifications for other types of contracts, such as term, par, universal life, etc.

Purists will undoubtedly object to the many oversimplifications in the formula. Such objections were voiced when the interest-adjusted net surrender cost index was first proposed by regulators, but it’s now universally accepted as an appropriate disclosure in life insurance sales.

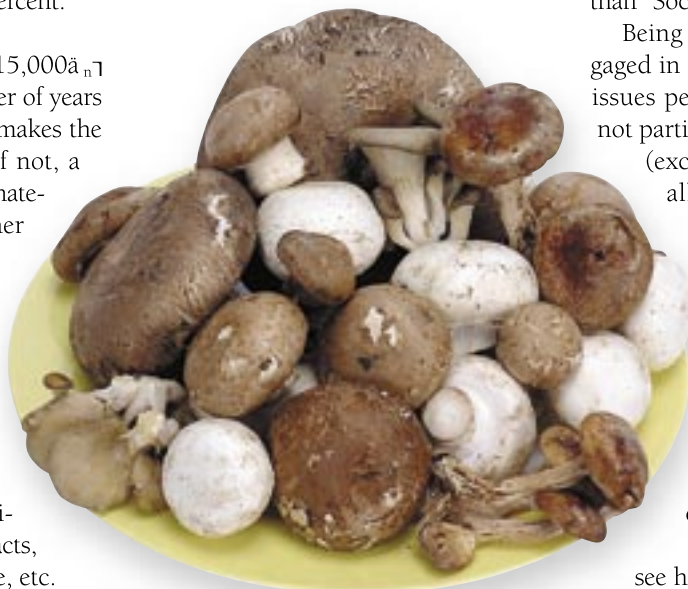
Perhaps others will suggest ideas for more appropriate cost-benefit analysis disclosure requirements for life settlements. I hope my proposal leads to worthwhile discussion.

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Long Tails, Short Memories

Richard Zatorski’s delightful article on the underwriting cycle (“Blame It on the Soup,” January/February 2005) put me in mind of a conversation I had with the president of Canada Re some years ago. I was researching the prospects for a new entrant into the property-casualty reinsurance market, which eventuated in the formation of MONY Re. While discussing the underwriting cycle, I commented that the business seemed to be one of “long tails and short memories.” He studied this observation for a moment, then said: “And doesn’t that exactly describe a monkey?”

ARDIAN GILL
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The Last DB Plan?

I just wanted to quickly commend you [Tip Parker] on your thoughtful and insightful commentary on stocks and Social Security (“How Can Stocks Help Social Security?” January/February 2005). You raise many critical issues with respect to this debate that’s really starting to heat up in Washington and across the country.

Overall, I agree with your findings that the stock market will not be able to sustain future baby-boomer retirement income needs. But with the public relations machine in high gear in Washington, you may not hear that view. Yes, absolutely, something needs to be done. But as you point out and I agree, the stock market is not going to be the panacea some would like it to be. The problem is that most Americans will not understand the points you raise and the questions you would like answered. They will just hear the spin about how much better stock market returns have been over the past 70 years than “Social Security returns.”

Being 39 years old, I am highly engaged in this discussion. One of my big issues personally is that I currently do not participate in a defined benefit plan (except for Social Security). I have all of my qualified retirement money in a 401(k)—in stocks!

Why would I want to have more retirement money at risk in the stock market? Social Security is the only guaranteed income I can expect. And the same goes for most people 40 years and younger, with the vanishing of DB plans.

There are a few things I can see helping the future retirement in-

come needs of the baby boomers. One, sustained, significant increases in the productivity of the nation's workforce. We will need to get more out of an ever shrinking workforce. Second, increased immigration to help replace the retiring boomers. The immigrants will need to be highly trained and have a skill the economy needs to grow (ditch diggers will not do it). Finally, have you considered the possibility that countries such as China and India will have younger workforces that may be willing to buy our financial assets at prices that can sustain a large retiree population?

Thanks again for your excellent article. Those who aren't convinced of the long-term benefits of Social Security money in the stock market must turn up the volume on our political leaders and force them to answer the tough questions before these immense changes are considered. What a challenge that will be!

AL JOHNSON
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Shock and Awe

I read Howard Bolnick's essay ("A Shock to the System," January/February 2005) on the dysfunctionality of prevailing health insurance risk assessment with a mix of awe and appreciation.

Awe for the seamless way his es-

say presents the facts; appreciation that someone of Howard's stature has finally presented them.

One reason we have 40 million *health-insurance-less* Americans is wastage of good business, occasioned by bad decisions (past, present, and more in the future if this essay is not widely read and taken to heart). These bad decisions are catalyzed in part by myopic views of the genuine implications of prevalent R, using Howard's excellent examples: statins for lipids, all genre of antihypertensives, and Prozac and its kindred for much more than just "psychiatric impairments."

By driving risk management with selection criteria out of phase with contemporary clinical reality, health carriers are—as Howard deftly shows—virtually "trolling" for disgruntled policy-seekers, irate producers, fired-up personal physicians, and less-than-amused regulatory authorities who will ultimately be petitioned in the most flagrant of these scenarios.

Hats off to *Contingencies* for hitting a publishing home run and to Howard for raising, as he does in this elegant essay, the bar of consciousness for an industry that sorely needs same from its rare (and priceless) visionaries.

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Passing Exams

There are several problems with the conclusions Professors Brown and Ciccotello ("Can Education Substitute for Actuarial Exams?" March/April 2005) reach: Full-time students who are able to take a course designed to help them pass actuarial exams pass exams more often than those who have to work and study. This is not exactly a surprise to anyone who has recruited in the past three decades. The problem is that passing exams is all that those students often know how to do and they are far less valuable to their eventual employer than someone who has been working and studying simultaneously.



Course work will only substitute for exams if we can be assured that the 50 percent who failed the exam wouldn't get a gentleman's C (or at Harvard it may be a B) and thereby receive credit for an exam they would otherwise fail. There's no way to prevent the universities from gradually lowering their passing requirements to allow all their students to receive credit for an exam.

More research isn't needed. Successful actuaries have been produced by both the academic and work/study routes. What we need to preserve, however, is the system of exams that has made our profession so highly regarded by our employers and clients.

CORRECTION

In the charts on Pages 40 and 41 of the March/April 2005 issue (Exhibit I: Pass Rates by Session), the colors of the key were reversed. The line designating students should be yellow; the line for nonstudents should be blue. The correct charts may be found along with the article ("Can Education Substitute for Actuarial Exams?") on our website at www.contingencies.org.