RECORD OF SOCIETY OF ACTUARIES
1976 VOL. 2 NO. 3

REPORT OF THE SPECIAL COMMITTEE ON VALUATION AND NONFORFEITURE LAWS

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Panelists: JOHN R. GARDNER, CHARLES GREELEY.

This is intended to be largely an open discussion of the "Report on Actuarial Principles and Practical Problems with Regard to Nonforfeiture Requirements" but will include a summary of written responses to the Report, developments on the regulatory scene, and recent work of other committees studying nonforfeiture or related areas.

MR. HENRY C. UNRUH: The purpose of this meeting is to give the total membership of the Society the opportunity to comment on and make constructive criticisms of the recently published report on Actuarial Principles and Practical Problems with Regard to Nonforfeiture Requirements.

The original charge to the Special Committee also required a report on valuation requirements. After several meetings of the Committee it seemed obvious that a comprehensive review of and report on both subjects would be so time-consuming that it would be next to impossible to estimate a date on which such a report could be published. The Committee felt that, since most of the discussions at Society meetings had focused on the problems of the Standard Nonforfeiture Law and since the two subjects were essentially severable, the Committee should concentrate on the Standard Nonforfeiture Law and recommend that a different committee deal with valuation.

Even with this limited charge it took the Committee two-and-a-half years to come up with the report and I want to give the Committee credit for working very hard. Fifteen all-day meetings were held with nearly perfect attendance at each meeting - with homework assignments given to the various members between meetings.

Bear in mind that the charge asked the Committee to review the practical problems of the law as well as the actuarial principles. This meant that the Committee had to wear two or three hats at all times. This caused us a great deal of difficulty, and the report spells out many of these conflicts.

The Committee, in its deliberations, analyzed and discussed thoroughly many different views expressed by individual members and sometimes I questioned whether we would come up with a report at all. Finally, however, the pieces began to come together and the report represents a general agreement.

We all realize that a handful of members on a committee cannot think of everything. That is why we are here. We want to have additional thoughts on the subject and publish them so that the regulators and other interested parties will have a complete record of all of the best thought on the subject. I might add that the report is already being studied carefully by the regulators and our Committee is in frequent communication with them, and, hopefully, after all the comments are in, a draft of a new bill can commence.

Before inviting a floor discussion, my associate John Gardner, a vice-chairman of the Committee, will make some general comments on the deliberations of the Committee and Charles Greeley, Secretary of the Committee, will review some of the written comments which have been received.

I want to emphasize that we are not here to answer all of your questions. I do not think we are smart enough to do that. We want to hear of other significant problems which the Committee may not have addressed adequately for further deliberation.

MR. JOHN R. GARDNER: Only when you get underway do you begin to realize the problems that a committee such as ours faces. Since we began three years ago, I have had three or four secretaries and each one I have had to teach how to spell "nonforfeiture" and to explain that when talking about the Guertin report, I was not involved in the pickle business.

The function of your panel is not to lecture to you; on the contrary, we wish to get discussion started and have comments coming back to us from the floor. To assist in achieving that objective, I would like to inject a little stimulus by taking a few minutes to describe some of the underlying concerns that were present in the gentlemen who formed our committee and ultimately influenced our report published earlier this year. I would like to think we were objective in our work; at the same time I know it was not possible to wipe away all of our preconceptions.

One of the very first questions we had to ask ourselves was whether we were to be an academically-inclined committee or were we to aim at output that might have practical consequences? We opted for the latter. In the initial stages we asked ourselves, why have guaranteed nonforfeiture values at all? Were they a good policy feature? Were they necessary? If we must have guaranteed values, why do we need guaranteed <u>cash surrender</u> values? Why not have a paid-up insurance benefit as the guaranteed nonforfeiture option and leave cash surrender values to be determined after issue?

Why not guarantee the method by which nonforfeiture benefits would be determined, but not the nonforfeiture values themselves? The actual determination of nonforfeiture values during the course of a policy's career would be left to the application of the guaranteed method to future expense factors. After several months of discussions that began with a clean slate, our committee decided that, to be practical, the fully guaranteed nonforfeiture values that are so much a part of the American scene had to be used as our starting point. We limited ourselves to looking at the regulatory environment that controlled these values and to seeing how it might be improved. I am not certain, however, that everyone in the room would agree that we should have guaranteed values in our contracts, and we may wish to talk about that question.

Secondly, the question was asked as to how nonforfeiture values and valuation reserves tie together. Our committee decided that the two concepts are separable. I am glad that we did, as I am quite convinced that our committee would not have had a report at this point in time, but would still be going around in circles. This separation was not an arbitrary choice; the committee came to the conclusion that the only linkage was a need to bear in mind

nonforfeiture values when valuing policy liabilities. Historically, nonforfeiture values may have been derived from valuation reserves; today, there is no justifiable linkage of nonforfeiture values to valuation reserves. Nonforfeiture values should be viewed as a policy benefit and treated just as death, maturity, and disability benefits are treated.

Another subject we tackled was equity. We started with the Guertin Committee definition, a definition I will paraphrase as stating that the company should give back, in the form of a nonforfeiture benefit, as much value as it possibly can, but not so much as to prejudice the position of those policyholders who continue their policies. At the same time, our committee had input that expressed concern over the position of policyholders who terminated in early policy years. One suggestion made to us indicated that the appropriate cash value for an early terminator would be return of premium less a term charge. We sensed that the answer to the question of what was equitable to the early terminator was not cut-and-dried. If we refunded premiums to the early terminator, a result unsatisfactory to the Guertin concept of equity would adhere to other parties somewhere along the line, since that early cash value would be well in excess of the asset share. We then looked at the position of the company, which has its own idea of equity. To the life insurance company, equity is the prospect of conducting its business of assuming risks while making a reasonable profit in the process.

With the recognition of that definition of equity, we realized that the one party that really had to come to grips with the question was the regulator. It is the regulator who assists the buying public, which is made up of both early terminators and late persisters. The regulator is also charged with the solvency and health of the life insurance company as it conducts its business. We decided really that there was no principle labelled "equity", but that equity was a convention, one that had to appear reasonable, but otherwise arbitrary. It is up to the regulator to make up his mind as to exactly what kind of balance is to be struck between the different parties involved.

Another issue we struggled with for some time was whether nonforfeiture values be constructed from a prospective view of the policy, or should they be built up by a retrospective technique? The prospective approach did not appeal to the committee, because it is considered as unintelligible to the great majority of the public, who find present values and discounting gibberish. If we supported the prospective approach, we did not feel we would be doing the industry a favor. On the other hand, the accumulation approach, which had initial appeal to us, raised the question, what do you accumulate? To get at nonforfeiture values by accumulating from the past, one has to decide what is to be accumulated. The obvious answer to that question is accumulate the gross premium, less expenses and benefit payments. Then, one is in the position where, through the nonforfeiture value mechanism, the entire price structure is regulated. Price regulation was not part of the committee's charge, nor is price regulation, as far as we can tell, part of any current trend in the regulation of the life insurance industry. We decided, therefore, that we should continue to live with the prospective approach in deriving nonforfeiture values and that we would work with some sort of adjusted or partially unloaded gross premium.

We embarked into the expense arena, asking ourselves, what is the level of expense today? One conclusion we felt comfortable with was that there has been a change in the pattern with the per thousand expenses applicable to the ordinary business of a company less today than they were 35 years ago, and with the per premium charges higher. We did not, however, have access to cold, hard data that would enable us to get a fix on the level of industry expenses. Next, we asked if we could preserve another of the principles of the Guertin Report. In establishing minimum values should expense factors be applicable to a marginal stock company, presumably a company whose expense pattern lies at the high end of the spectrum? We sensed that here resides an issue that has to be resolved by the regulator once data is made available. Is it still feasible to take the Guertin approach or must the expense allowance built into the regulatory environment reflect the performance of more efficient companies?

The last area I would like to refer to at this point has to do with product-oriented problems. We had evidence that there were a number of products that appeared not to contain equitable nonforfeiture values while abiding by nonforfeiture requirements. Indeed, some products seemed designed with an eye to taking advantage of nonforfeiture requirements, by minimizing nonforfeiture values without conferring other benefits in a fair or equitable quantity. When not concerned with products that seemed to get around the spirit of the nonforfeiture regulations, we were presented with new products, such as cost-of-living policies and life cycle products, that keep running afoul of nonforfeiture regulation requirements so strict and so rigid that they cannot be sold.

We felt there had to be some change in the regulatory environment to permit these contracts to be made available to the buying public. Finally, there are some products that are unregulated. Disability income is one; annuities and sections of the term insurance business are another. We wanted to look at these product areas to see if anything should be done.

MR. CHARLES GREELEY: What I would like to do is go over the Summary of Conclusions in the report point-by-point. After referring to our Committee's position in each of the thirty points, I will report anything that I got in the mail from the membership. I will also report in a general way the thoughts of the ALIA Actuarial Committee. Finally, since we do not have a regulator on the panel, I will report as best I can the reactions of the NAIC Technical Subcommittee on Nonforfeiture.

The first point is a summary of the general conclusion of the first twenty or so pages of the report. We did receive several discussions regarding the later technical points and many of these discussions made some remarks about general approach and equity. There was nothing that could be read as critical of the first conclusion that we should follow the general Guertin approach. Although everyone had some degree of concern as to what is equitable these days with consumer trends, etc., I will say that both the NAIC Technical Subcommittee and the ALIA Actuarial Committee endorsed this general conclusion.

MR. E.J. MOORHEAD: Even though there were, as stated, no substantial disagreements about what minimum surrender values should be, it is obvious from simply reading the names of the members of this Special Committee that there must have been much refreshing and stimulating debate which ought not to be lost in the cosy unanimity and orthodoxy of the printed document. It is to be hoped that the Transactions will reveal the particulars of some of the philosophical stances that surely must have been taken.

On the philosophical plane this reader encounters particular difficulty with two statements in the Report -- not because these statements are false but because they are too confining. I also believe that the Report would have been better had a question been discussed that seems to have been taken for granted. I will attempt to deal with these matters.

On page 10 it is said that equity is in the eye of the beholder. Surely this should be qualified by asserting that equity on the subject we are discussing depends upon the manner in which life insurance companies and their agents describe the product to those whom they undertake to persuade to buy it.

The occasional protestation, usually made for a particular purpose, that the savings feature of a level-premium policy is incidental to its primary purpose is not at all in harmony with the representations made in sales promotion material and in countless sales presentations. If life insurance is offered as a savings plan this implies that the company expects to provide a benefit to the terminating policyholder that is reasonably in balance with, and not completely secondary to, the benefit ultimately accruing to the beneficiary of the continuing policyholder.

Furthermore, there has in recent years been a large change in the relative numbers of terminating and continuing policyholders. Many of the former are not withdrawing from being life insurance policyholders; they are replacing an existing policy by a new one. The concept of, or at least the clear distinction between, departing and continuing policyholders is close to becoming outmoded.

On page 13 it is said that none of the Committee members had the aim of revising the current distribution system. Perhaps the word "revising" may have been poorly chosen; "abandoning" may have been meant. A wrong industry decision about the relative treatments of continuing and withdrawing policyholders may place the current distribution system in greater jeopardy than any proposed modification that the Special Committee may have discussed. Also, loyalty to the present system must not cause us to support all its excesses and blemishes. For example, to require agents whose early lapse rates are chronically bad to give up some of the reward for having "consummated a reasonable and legitimate sale" might conceivably permit payment of more liberal cash values, and yet not be an unacceptable revision of the current system.

The question that seems to have been taken for granted by the Special Committee is the justification for level-premium life insurance. Originally the idea was that the need for protection exists throughout one's lifetime, and the level-premium system is necessary to avoid the spiralling costs at advanced ages. This was before the days of mandatory retirement for so many people, before the days of private and public pension benefits.

Under modern conditions level-premium life insurance is more of a convenience than a necessity for most people. It provides an opportunity for building a fund that usefully supplements other savings and can result in a supplementary retirement income. Since the choice between term insurance and whole-life insurance has become more and more closely related to the attractiveness of the fund that the whole-life form guarantees, it appears that the Special Committee might have given consideration to a definition of reasonableness expressed in terms of the yield on the excess accumulated premiums, comparing whole-life with term. Applying the arithmetic of Linton's Method gives an identification of equity that strikes this observer as consistent with both theory and practice in modern level-premium insurance.

This introduces two matters that the report does not cover at all. One is the difference between participating and non-participating insurance and the other is the equitable value according to the size of gross premium for a non-participating policy. The section of the report that demonstrates with actuarial finality that minimum values can be the same regardless of the gross premium is less than entirely comforting; I wonder whether that is a stance that the industry ought to take. The essence of my proposal deals with the section of the report in which we are talking about the equitable value rather than the minimum value. I do share with the committee the idea that in some way, vague or clear, those two are linked together. I am not quite sure how they are linked together, but in some way they must be. The committee thought so, but started talking about equity and then going on to minimum guarantees. I think it would have been very helpful if the committee had given us information that they probably have collected on the extent to which minimum values are being used by companies today, separating participating policies from non-participating. It would be very helpful to know more about that subject in order to appraise the practical importance of the minimum values that are legislated.

MR. GREELEY: Are there any views supporting Jack Moorhead? The approach that our committee took was that the purpose of nonforfeiture laws is to maintain relative equity between early, middle, late lapses, and so on. Our approach was just like Guertin's and not a question of relating cash values to gross premiums.

Point 2 is the simplification in the expense allowance formula. No one that we heard made any comments on this particular point. I think it has been taken by the NAIC as being a technical improvement in the formulas.

On the third point, we had quite a few reactions. Mr. Corbett of Safeco, Seattle suggested that up-to-date factors which would get cash values close to asset shares would be highly desirable. Mrs. Emory, reporting in The Actuary, made the same comment. Mr. Lauer of Penn Mutual asked: what justification did we have for suggesting a shift away from the per thousand component in the direction of per dollar premium component? Mr. Lauer also expressed regrets that our committee chose not to recommend any specific expense factors. Charlie Richardson of the NAIC Committee agrees with the principle, but is planning to make expense studies. Incidentally, our committee did not have the facilities for making detailed expense studies or contacting the dozens of companies who probably ought to be contacted to get views. I believe the NAIC groups, through Mr. Richardson, will be trying to do this, and also attempting to see whether a reduction in minimum cash values might result in a lower level of gross premiums.

No particular comments on points 4, 5, and 6 which our committee considered self-evident theoretical improvements in the formulas. The NAIC group, quite rightly, wishes to test some of these simplifications in the formulas against actual examples. I believe they are going to look at policies with unlevel amounts and unlevel premiums that are submitted to them for approval.

MR. ROBERT J. BOHN: Was any consideration given to measuring equivalent level amounts on increasing benefit policies for 20 rather than 10 years? We do feel the need of having that period to get enough expense allowance.

MR. GREELEY: We did discuss this point, I am sure a case can be made for 20 years as well as for 10. Our Committee's thought was that the purpose of this type of allowance was to cover underwriting costs and companies would not really incur underwriting costs on account of larger death benefits after 10 years. It may be that, in the aggregate, when you look at this factor and other factors, the expense allowance will be in total too tight.

Point 7 was a highly technical point, and perhaps expressed obscurely in the report. The NAIC group asked us to demonstrate more clearly what we meant. Such a demonstration was given to them and they have now agreed with the point.

Points 8 and 9 are the kinds of policies which are hard to develop under the present law. The NAIC group wants to test them against actual examples, and asked our committee for a demonstration. This has now been done for a cost-of-living type policy, where you do not know what the index is going to be in advance. Mrs. Emory was disappointed that we did not specifically allow an assumption at issue of a specific cost-of-living index, as a permissible alternative to having it completely open. Mr. Koppel of the Combined Insurance Company of America feels that a new expense allowance should not be available upon increases on cost-of-living or other open policies.

Point 10 is something of a political question. We recognized that some of the individual departments would have difficulty in their approval procedures if the law was vague on some of these open policies. We, therefore, suggested the possibility of a single national review body. In response, the NAIC Technical Committee believes that it would be appropriate if it were established as a central reference source for questions regarding nonforfeiture. Mr. Moskowitz of Sun Life in Baltimore expressed his misgivings about the idea primarily because of the desire for individual independence by the regulators. On the other hand, Mrs. Emory supports the idea and would like to expand it.

MR. MOORHEAD: I would like to urge the committee to consider the words "particularly of complex policies" because if those words were out, it happens to support a view that I have already expressed to the National Association of Insurance Commissioners. Last year, at their request, I wrote a piece that I think most actuaries have not seen called "A Report on Manipulation." The word was not invented by me, but I was asked to consider what steps regulatory bodies could take to curb manipulation of policies, so as to take advantage of whatever method is in vogue for cost comparison. I did not reach a conclusion that manipulation was going on. I did say

that if there could be a central body reviewing the structures of policies that are up for approval, that body would develop a feel for the subject that would enable them to distinguish between policies that are fairly free of any such manipulation and policies of which they might have reason to feel suspicious. I hope that the committee will support this idea for reasons beyond just the complex policy. There is the risk of federal takeover if they began to have central bodies doing work for all the states. It seems to me that objection to a central body is not justified. The survival of state regulations may, in the long run, depend upon a greater willingness of the individual states to pool their resources in order to get these jobs done more effectively. So, this is an appeal for strengthening of point number 10.

MR. WILFRED A. KRAEGEL: Ten years from now when actuaries look back at the Summary of Conclusion of the Special Committee, I believe they will regard Items 8, 9, and 10 as having had the greatest significance. The Committee's concern about leaving the way open for innovation is extremely important. The provision for multiple track policies and life cycle/open policies of various kinds is vital to help the industry keep up with changes in the economy and with consumer needs. I would be interested to learn of any particular points or problems which the Committee discussed in that area.

I would also like to add my support to the point just made by Jack Moorhead, that a single national review body to facilitate policy approval would be desirable for most or all policies, not just for complex policies.

MR. ROBERT L. PAWELKO: I appreciate the opportunity to explain the basic thought process that went into the recommendation of the NAIC Central Office. First, that office acts as the coordinating office for the NAIC. That is, the Central Office is funded by the individual state insurance departments and its responsibility is to tie together meetings, monitor NAIC projects, prepare various reports and distribute such reports to the various states, and, in general, tie together the various insurance departments and their operations. The office in many respects is similar to the Society of Actuaries office in Chicago. It does not set NAIC policy but is certainly instrumental in carrying out such policy.

My suggestion was not aimed strictly at the policy form approval problem which we have been discussing previously but rather encompassed the entire operations of the insurance departments. I recommend that the NAIC Central Office or some other central body of that type be set up with a full staff of actuaries, accountants and lawyers and it would act very much like a professional consulting firm whose only clients are the fifty states. The accountants in the office could either perform or at least supervise all company examinations. The actuaries would also be involved in the examination process from a review standpoint. From a policy form approval standpoint, the actuaries could review policy forms before submission to the individual states. Thus, a company could submit its new policies to the NAIC Central Office whose staff would review the policy to determine whether or not it satisfies the technical constraints of the Standard Nonforfeiture Law. Once a policy has been reviewed and approved by the NAIC Central Office, individual state approvals should not be as difficult as they are now. The entire review and approval procedure, in fact, would hopefully reduce to submitting a form to the NAIC Central Office for complete approval in the various states without the need for the states themselves to review the policy forms.

My recommendation was aimed at providing and establishing a professional operation consisting of actuaries, accountants and lawyers which would serve the various insurance departments. The comment has been made that this recommendation is more political in nature than technical and, as such, does not belong in the Society of Actuaries. From a purely technical standpoint I would agree. However, there are more than a few people in this audience who are presidents of their companies. Actuaries themselves are involved at the very highest levels of the operations of virtually every insurance company in the United States. We have the ability to see some of these problems and in my opinion we have the responsibility to do something to try to correct these problems. I believe that the Society of Actuaries is a very logical starting place and I am most hopeful that we as a Society can begin exercising our muscle in the regulatory scene to help improve it.

The NAIC Central Office offers one vehicle through which such a central body could emerge. There may be other approaches to doing the same job. I do not believe that a consortium of insurance department actuaries can do the type of job that is necessary for this type of approach to work. For one thing, all insurance departments are subject to budget vagaries. It is simply impossible for these actuaries to be on call and to have the ability to meet at any time to review the number of forms involved. In addition, actuaries working for the individual insurance departments have a vested and perhaps prejudicial interest based on their own state laws. Other states may accept or acknowledge the opinions of these state employees. Employees of a central body, however, would truly be representative of the entire 50 states.

Again, I believe that the NAIC Central Office is the best approach to resolving some of these long-standing problems that the insurance industry is faced with. It certainly offers an ideal vehicle for the approval of unique policy forms as we have suggested in our report.

MR. GREELEY: Moving on to point 11, our committee did not recommend a specific interest rate. Mr. Corbett made the suggestion that regulators be able to set interest rates periodically rather than have the rates frozen in the law. I believe the NAIC group may be inclined toward a higher interest rate minimum than the $4\frac{1}{2}$ percent that was used for demonstration purposes in the report. They are looking into, among other things, graded interest rates starting at $5\frac{1}{2}\%$ or 6%. The ALIA agrees that this is a matter that needs a study, along with the expense factors.

MR. GARDNER: This particular aspect of our work caused me concern. Throughout our discussions, I sensed we were under pressure from consumers to come up with ways of providing bigger nonforfeiture benefits. Yet, to be realistic, we had to recognize the impact of today's higher interest rate climate on minimum values. It does not take long to see that high interest rates push down nonforfeiture values, whether it is the actual policy value or the minimum value. I was interested in the attitude of the NAIC, who are willing to discuss graded interest rates. Indeed, they do not appear to shudder when talking about a 6 percent initial interest rate for nonforfeiture value requirements. By incorporating realistic current interest rates in the nonforfeiture mechanism, we gain some relief from some of the problems occurring today because of fluctuating interest rates and the difficulties of getting a fix on asset values. In other words, we would still have guaranteed values, but those guarantees could be pushed down far enough to take off of the system some of the pressure that bothers many people.

MR. JEROME S. GOLDEN: Mr. Greeley mentioned that the NAIC was considering the use of graded interest rates in defining minimum cash values. Such an approach might produce problems under Article IV, Section 2.h. of the NAIC Model Variable Life Insurance Regulation which defines the method of computing cash values and other nonforfeiture benefits under VLI policy. The section of the NAIC Model presupposes that there will be a constant maximum rate of interest under the Standard Nonforfeiture Law.

MR. GARDNER: I think if you study closely the section of our report that supports this recommendation, you can see more clearly what we were trying to do. We recognized that nonforfeiture values should be tied in as closely as possible to asset shares. We believe that this approach contains the most acceptable definition of equity. We also wanted to determine the effect on minimum requirements of making all assumptions modern. We systematically looked at what modern expense, modern interest, and modern mortality assumptions would do. We did not specifically state an interest rate that we felt was applicable. The Society already has a separate committee looking at this question. What we did was show the impact on nonforfeiture values of increasing the interest rate. The discussion in the report is more fruitful than the wording in the summary would suggest.

MR. JOHN C. MAYNARD: I wonder if I could just pose one question on this subject of interest rates. I am going to refer to a development that has taken place since the report was written, and that is the proposal that new money interest rates should be used on ordinary life policies. This is being discussed and examined rather broadly and we had a concurrent session dealing with this subject this morning. When you come to cash values, this poses a question for you. If you are going to give new money interest rates and credit them for the use of policyholders who have an annual premium policy, then you are giving away the interest quite exactly. As premiums come in, you are attributing the interest to the growth in the assets corresponding to the policy and you are making sure it goes right to the person who produces the growth in assets through premium payment and interest accumulations. If you are going to give all of this to him, then what do you do if the capital value of the asset changes? Who is going to bear the weight of that? This leads to the conclusion that the new money interest rate requires amounts on surrender to vary with the asset value. This seems to be an argument for having surrender values vary with economic conditions corresponding to the use of the new money interest rate in the rest of the design and control of the policy.

MR. GARDNER: If in the pricing and management of ordinary insurance products, the investment earnings credited to blocks of business are on an investment year basis, it would seem that one of two approaches will have to be taken in the regulation of cash values. Either minimum requirements will have to be knocked down substantially so that guaranteed values can be much lower than they are now; or the concept of guaranteed cash values will have to yield, as the values to be paid on surrender would have to take into account fluctuations in asset values. Our committee recognized the theoretical solution of having nonforfeiture benefits not guaranteed. We did not really believe such an approach would be acceptable in today's climate, and decided not to pursue that avenue. If the interest earnings credited to ordinary insurance are on a new money basis and if new money interest yields remain high, our report would support the use of a higher interest rate in the determination of minimum guaranteed benefits.

MR. GEORGE N. WATSON: Although in North America guaranteed cash values are considered to be an essential part of the life insurance system, we should keep in mind that in some countries this is not the case. In England, cash values are usually not guaranteed in the policy. In times of severe market depression, the absence of guaranteed cash values might well make the difference between solvency and insolvency of a life insurance company. An alternative system for guaranteed nonforfeiture values would be a scale of guaranteed paid-up values in the policy with the provision that cash values would be payable by the company upon request according to a scale which would be computed from time to time based on an appropriate rate of interest according to current conditions. The cash value would be the present value at such rate of interest of the guaranteed paid-up value in the policy. This is a procedure which we are considering at the present time in Great Britain and would be especially valuable in periods of high interest rates and depressed market conditions.

MR. GREELEY: Turning to mortality, points 12 through 15, everyone agrees that a new table ought to be constructed and I believe the Society of Actuaries has appointed a committee to construct it. It was our committee's view that margins were a matter of some importance in the valuation area but of not too much significance one way or the other in the nonforfeiture area. We did feel it would be desirable to have the same table for both. Mr. Corbett expressed some views about margins not being necessary. I believe the NAIC will study this further. As to the matter of 6-year setback, no one wrote that it would not be appropriate. However, it would appear the political climate makes it highly likely that separate tables by sex will be the thing of the future. I know the NAIC subcommittee feels quite strongly that this is the only acceptable way. Their view is that we have two practical alternatives, unisex table or separate tables, because the use of a setback implies an approximation or favoritism which is not politically acceptable. The ALIA has taken the same position that it is time to construct separate tables. I believe the Society of Actuaries Committee is constructing separate tables by sex.

MR. GARDNER: Having separate male and female mortality tables is a reasonable solution to the problem. I suggest, however, you decide how you are going to respond to lady policyholders who want to know why, in spite of a separate female table, they have lower cash values than their male counterparts. You will have to set your imagination to work to figure out how to explain that outcome.

MR. BERT A. WINTER: The Standard Ordinary Male and Female tables to be developed by the Society's newly appointed Special Committee should permit tests which give further assurance as to the reasonableness of defining the minimum nonforfeiture values for policies issued on female risks as the SOM minimum for a male no more than a statutorily specified number of years younger. This should enable the companies to develop gross premium rates which accurately and equitably reflect their experience by sex. Such rates would not be increased to provide for additional expense in the preparation and maintenance of separate rate books and administrative tables. A pertinent analogy is the procedures long followed for comparable differences in mortality experience of the lower-rated classes of substandard risks.

MR. GREELEY: The NAIC is not trying to change as far as I can tell the way in which the industry recognizes the impact of sex on mortality. What they are saying is,"Where the distinctions are made, they want to see separate tables." I think what we will have to come up with are two tables, one for male and one for female and then perhaps a combined experience table. I really cannot see, if the NAIC's interpretation of the climate is correct, the industry continuing to put out a common set of nonforfeiture values for males and females based on a male table. I think most companies will probably continue to use a common set of values, but they must be based on some kind of combined experience table.

MR. THOMAS K. GROSS: Is there a regulatory desire to require separate tables for female cash value calculation? I hope not. Since most companies do not have different cash values for females now, this would result in ratebooks twice their current size.

MR. GARDNER: I recognize the pressure for increased recognition of the different mortality patterns of the two sexes. I do not see why the difference must be made in dividends, in premiums, and in cash values. Allowance for the mortality difference in one or two of these features can lead to an appropriate distinction in the product.

MR. GREELEY: As for points 16 and 17, the idea of the test for triviality seems to be acceptable, but the NAIC is exploring alternative tests for triviality. I do not think it matters too much precisely what test for triviality ends up being used. The goal is the same: policies which essentially have no significant cash value should be exempted. It seemed to our committee that no matter whether or not a triviality principle was brought up, it would make sense that anything which is obviously straightforward term insurance should be exempt like it always has been, and,as a matter of fact, extended a little bit to 20 years instead of 15. The NAIC group is hoping to somehow have a single test that will cover both triviality and term exemption. Mr. Moskowitz asks why is there need to exclude term insurance specifically, if it is going to be excluded on the triviality principle in any case. I guess the answer is that 20-year term at the higher ages would not be excluded under any triviality test, because of the slope of mortality. It would be undesirable if it were to be required to have cash values on 20-year term policy. Our committee therefore recommended that both tests would continue to be used.

MR. BRUCE E. NICKERSON: I find the conclusion concerning renewable term a particularly difficult one personally. With the provision for extending the general term exemptions and with an appropriate test for triviality, this provision seems to be unnecessary. By modifying the premiums periodically so the product is not entirely level term and calling the modifications, renewals, then you may disregard the test for non-trivial cash values. Is this not a potential area for what Mr. Moorhead might refer to as manipulation?

MR. GARDNER: It is important to remember the process that goes on in dealing with trivial values. I have to sit down with a product and go through the calculations that generate nonforfeiture values according to the minimum standard. I may then find out that the minimum values are small, small enough to be labelled trivial by law; therefore, I do not have to put them

in the policy. To avoid that time-consuming process of determination, I would like to find a test that is simple to apply. For example, it is very easy to note that the policy is 15-year term insurance, and does not need values. This second process does not take time with people going through calculations or writing computer programs. Our committee concluded that the typical term policy with a renewal feature occurring at frequent intervals and a step-rated premium structure would have equitable nonforfeiture values that were generally trivial. To avoid the process of going through all the calculations, we decided it was more efficient to say that renewable term insurance should be treated as a series of separate short-term policies. While this approach does give scope for some manipulation, the alternatives would have been the killing of the fly with a sledge hammer.

MR. NICKERSON: How does one distinguish between a renewable term policy and a step-premium policy, which produces significant values?

MR. GREELEY: Before answering this question, I will report general agreement from the NAIC on point 18 (severability principle) and point 19 (definition of term). As to Mr. Nickerson's question, on pages 47 and 48 of the report, we attempted to explain this. Each contract contains a brief description of its nature and should be treated for nonforfeiture purposes as the coverage it declares itself to be. I think the regulators should use judgment to see whether a particular policy that declares itself to be term is really a sham, because, for example, the premium only goes up 2 cents every 10 years. That really is a sham, but if the premium goes up more or less in the same way as a new issue, that is clearly not a sham. So if it declares itself to be term and it looks like term, let it be term rather than find some esoteric reason why it is not term. When you try to avoid abuse by legislation, I am afraid that the ingenuity of some people to overcome obstacles may be beyond control. In the meantime, it would be a pity and poor business if plain term insurance should suddenly be required to have tables of cash values.

We looked for ways of changing the law in two respects: Make it more flexible so that desirable and legitimate improvements in product design can be made, and on the other hand, control abuses a little bit better than is the case now. We have no illusions that we will be able to ever draft any law that will be foolproof as to avoiding abuses.

On point 20, the net effect of deposit term has been that an initially larger amount of money was not returned to the policyholder for several years after issue since under the present law the expense allowance was based on the size of the first premium. Our proposal says that the expense allowance should not be based on any one premium, but on the levelized net premium. In effect, it is saying, look at the policy's benefits. Ignore its pattern of premiums for the purpose of determining the amount of expense allowance. Of course, you work it off proportionately to the gross premiums, but the amount of expense allowance is not suddenly doubled or tripled just because the first premium is two or three times bigger. Not unexpectedly, there has been some opposition to this recommendation. Initially, both the NAIC and the ALIA groups agreed, but now the NAIC has discovered certain types of deposit plans for which they believe the approach does not cure the problem. We received a letter from Mr. Halstead of Kemper Life in defense of deposit term as a means of paying agents adequately for selling term insurance.

Point 21 is important because it is removing the linkage with the valuation and the policy cash value rate. The present law, I think, has either a half a percent or no difference between valuation and nonforfeiture rates. Furthermore, the minimum cash values under any one policy depend not on some absolute minimums, but on the minimums calculated using the actual cash value interest rate. We propose a single interest rate for statutory minimum cash values such that only one set of minimums applies.

We got a couple of letters related to point 22. Mr. Cooper of Acadia Life in Toronto expressed concern about the dangers of insolvency on account of market value losses. He was quite pleased to see the idea of modernizing factors. Mr. Corbett felt the effect of modernizing factors, both as to interest and expense, would generally tend to result in higher values for the insurance options and lower values for cash. Both of these gentlemen expressed support of this part of the recommendation.

On point 23, Mr. Phillips of the Aid Association for Lutherans emphasized that the use of a CET table should be optional, not mandatory. The point is well taken. It is optional in the present law and we had no intention of suggesting anything different. No particular discussion was received on points 24 through 26. Mr. Corbett, writing on point 27, pointed out how the present law in effect forced companies to charge too high a premium on a single premium policy. Skipping for the moment, point 28, Mr. Lauer asked why there should be no cash values on disability income policies (point 29).

MR. UNRUH: Using the experience of my company, we developed asset shares for disability income policies. To test emerging values for non-triviality, we draw an analogy with term. Gross premiums per $1000 of term to age 65 were almost identical to premium rates for $30 of monthly income on the typical disability income policy with accident and sickness benefits to age 65. It would seem reasonable to equate $30 of disability income with $1000 of term to age 65. With a $30 to $40 basis for non-triviality, asset shares generally fell well within this limit.

MR. GARDNER: There is another factor at work. A principle of any insurance operation is that the insurer must eliminate or at least control the possibility of an insured selecting against him. Any time a premium comes up for payment, there is a selection exercise undertaken in the mind of the insured. With cash values in disability income policies, I believe you will find the degree of selection exercised against the insurer becomes much steeper.

MR. GREELEY: With respect to the list of miscellaneous technical matters listed under point 30, Mr. Phillips wrote to say he wants to make sure both curtate and continuous functions will be automatically permitted. The NAIC reacted to the item "removal of any requirement for complex or confusing policy provisions relating to cash values" by saying that thirty years from now a policyholder might as a result have difficulty getting answers from an Insurance Department, since files would not be kept for decades in the various departments. Yet they see the fact that confusing information like this is going against the movement toward simplification.

MR. WINTER: The Nonforfeiture Committee's suggestion for removal of any requirement for complex or confusing policy provisions relating to cash values should be favorably considered. The situation has improved since the present law was enacted. We may also anticipate improvement from adoption of other measures suggested by the Committee, such as formula simplification, treatment of varying amount and other unusual policy features, and a staff in the NAIC Central Office to deal with technical problems.

MR. GREELEY: I would now like to return to the point 28 that was skipped, the subject of deferred annuities on which there has been a lot of activity since the publication of the Unruh Report. As to correspondence received, Mr. Lauer, and also Mr. Miller, consulting actuary, expressed hope that cash as an option would not be mandated in the law. The committee said that cash should be generally available under normal circumstances, but left an opening for special situations. Mr. Blake of Acacia in Washington, D.C. wrote a lengthy and thoughtful paper on annuities. He has several points and I will just summarize some of them. He expresses the desire that flexibility would permit both level and front loaded products. He would hope that a special separate premium tax allowance would be made and the artificial distinction between so-called group cases, which are really individual cases, be removed. He would hope a table of values would not have to be shown in contracts on flexible cases. Finally, he introduces a principle of reciprocity: approval by the home state of the deferred annuity contract should automatically mean approval in all states. I would say that is rather close in idea to Bob Pawelko's idea of a Central Office, but of course, Mr. Blake goes much further and asks that there be an automatic approval.

Now for a reporting on further work being done. In addition to Henry Unruh's committee having continued in existence since we published the report, ALIA formed a subcommittee of the Actuarial Committee to study nonforfeiture on annuities, because several states were considering regulation or legislation. For many years only New York and a couple of other states had any annuity legislation that had any teeth in it. I believe that Indiana, Utah, and Tennessee have passed nonforfeiture regulations or legislation on annuities. Each of these states have taken paths which are different from one another. Thus, it is extremely difficult to do annuity business nationally without having to have different policy forms. The ALIA thought that it would be highly desirable if a specific proposal could be made on this subject and as a result the committee has worked on this subject for about eight months. The result of the work in general is acceptance of the Unruh committee's recommendations, but with more details spelled out, including a report and some specific legislation. The recommendation is a retrospective method tying nonforfeiture values to gross premiums, with certain specified loadings. It is proposed that cash as a nonforfeiture option not be mandated, but with strict controls and disclosure. Also, if a contract has a cash lump-sum settlement, it must have cash values at all durations.

This was roughly the gist of the ALIA proposals. We have met with the NAIC committee which recognizes the subject as a pressing matter. At the meetings, there has been understanding and general agreement on matters of principle, with some disagreement on amounts of expense allowances.

MR. STARR E. BABBITT: It has already been pointed out that a new committee is at work on nonforfeiture benefits for annuities. To that extent my remarks do not apply. But the January, 1976, report sort of brushes off flexible premium deferred annuities and some states are already passing laws without model legislation.

The report mentions a surrender charge or loading based on some percentage of the first "x" dollars, etc., but dismisses it because it is difficult to determine "x". The report seems to favor a maximum loading based on percentage of the first policy year's premium.

To me this is wrong because flexible premium deposit funds are best suited to IRA's where it is necessary to provide flexibility. A policy year approach limits flexibility. In effect, it means you have to reserve the right to force cash surrender if the policyholder does not pay "x" dollars of premium in the first policy year. Otherwise, the prudent policyholder will pay whatever your minimum monthly premium may be, just to get the contract in force, and then pay no more until the second policy year.

MR. GREELEY: Part of our way to try to resolve that problem was to permit a first-year load on an increase subsequent to the first year. The contractholder will end up paying the first-year load on the biggest amount of premium he has paid in any one year, whether it is the first or subsequent. That is not necessarily the best solution, but we did consider several others and this is the one that we finally agreed on.

MR. GOLDEN: The current version of the Standard Nonforfeiture Law provides, in substance, that the cash value under a policy continued as a paid-up nonforfeiture benefit shall not be less than the present value of future guaranteed benefits. Thus, if a policy provides, say, a period of extended term insurance in excess of that otherwise provided by the cash value, the amount of cash value payable under the extended term benefit would have to be based on the longer extended term period. For example, a company might want to provide that, for lapses during the first policy year, a minimum period of extended term insurance equal to three times the period for which premiums have been paid. If the cash value associated with the longer period would be payable, costs might be significantly increased on this benefit liberalization.

I believe that the Standard Nonforfeiture Law as modified should permit a policy to provide the longer extended term period without having to provide the higher cash values associated with the benefit, provided that the policy otherwise complied with the law.

MR. GARDNER: We tackled this problem from a different starting point: the principle of mathematical equivalence requires that an expensive purchase basis be used to obtain paid-up insurance benefits, thereby creating many small benefits that are a nuisance to everyone. We suggested it would make sense to permit as an option that paid-up benefits be provided on a current experience basis, perhaps on new money factors or on a basis that would apply to single premium contracts. We then asked ourselves exactly the same question you are raising: how do you avoid providing the inflated cash value for the bigger paid-up benefit that the low interest rate of the normal minimum standard would require? By exercising the option, there would be an automatic increase in the cash value in the policy. We recommend that, where

such a paid-up benefit is provided, the cash values applicable to that paid-up benefit be derived on the purchase basis.

MR. GREELEY: The next step is that the ALIA has agreed to draft legislation based on the Unruh Report, hopefully in the next few months. It will of course be distributed to give interested parties the opportunity to comment.