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CURRENT ISSUES IN INDIVIDUAL LIFE DIVIDENDS

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1. What criticisms have been made of life insurance companies' handling of dividend apportionment and dividend illustrations for individual life insurance and annuities?
2. Should actuarial organizations respond to these criticisms? If so, can this be done by formulating appropriate Guides to Professional Conduct and Opinions as to Professional Conduct?
3. What position, if any, should actuarial organizations take with respect to the following specific issues?
 - a. The basis of dividend illustrations and the relationship of illustrated dividends to dividends being paid on similar policies in force.
 - b. The treatment accorded the several experience factors (interest, mortality, expenses, etc.) in dividend scales, including specifically the question of portfolio method vs. investment year method.
 - c. What constitutes equity between classes of policyholders?
 - d. The degree of disclosure that should be made of company dividend scale particulars and illustrative dividend practices.

MR. J. EDWIN MATZ: The purpose of this program event is to discuss dividend philosophy and dividend practice with the aid, we hope, of the interim report of the Special Committee appointed last year to examine that broad field. As Chairman of that Committee I am automatically assigned to referee the discussion. Three members of the Committee will briefly review three specific aspects of the subject:

1. Bart Munson will remind us of some of the key words and utterances indicating the present levels of concern about dividend practices.
2. Harry Garber will outline the attempts of the Committee to devise statistical tests which could be used to demonstrate consistency of a company's dividend scales--and the reasons why those attempts failed.
3. Tom Sutton will offer a few comments on the route which the Committee now feels must be pursued: the devising of appropriate Guides and Opinions governing the professional conduct of actuaries in their dividend work, together with whatever accompanying regulatory action might be necessary to facilitate disclosure of dividend practices.

When these introductory remarks have been completed, we will then be ready to move to the real purpose of this session, to hear from you.

Finally, let me offer just two observations about the work of our Committee:

First, a great many actuaries have been looking over our shoulders, hoping for or expecting specific actions. At this time there is bound to be a lot of disappointment and dissatisfaction.

Second, one man's meat is another man's poison, in this instance as in others. There is hardly any specific instance of dividend practice which would be decried unanimously by all actuaries; some actions which have been publicly criticized would draw a fairly even division of yeas and nays, if put to a vote.

But let me make it clear that our Committee does not take a determined stand in defense of the status quo. While it may be difficult to separate sin and virtue, and a clear course through purgatory may be hard to define, we do believe ways can be found to shed more light on dividend practices than has been true to this point--and our business can only benefit from that process of disclosure.

MR. BARTLEY L. MUNSON: Quoting from Appendix A of our Committee's Interim Report:

"The computation of dividends has always been a major responsibility of the actuary. Its execution has varied aspects, ranging from the management of office systems for the distribution of dividends to the resolution of philosophical questions underlying the dividend scales."

This morning we're going to be talking about the end of the range dealing not with the nuts and bolts of "management of office systems" but rather the seemingly more esoteric "philosophical questions underlying the dividend scales."

The critics of current practice can be grouped as "them" and "us". "Them" are the non-actuaries, and they are the ones who offer the criticisms. "Us" are the actuaries and are the ones offering not criticisms but rather concerns. I believe often it's really only a matter of who makes the observation, whether it comes from a critic or one who has loving, understanding concern. There have been many sources of both kinds of observations to warrant the profession's attention.

The outside critic often seemingly has fallen into the trap of a faulty syllogism which goes something like this:

1. If you were trying to deceive and cheat the insurance buying public, you would not make your practices clear to me and thus I would not understand them.
2. You don't make your practices clear to me and I don't understand them.
3. Therefore you are deceiving and cheating the insurance buying public.

Still, let us not make the serious mistake of believing that, while the critic's logic thus may be faulty, he is attacking a totally defensible position. He is not, in the opinion of a large number of actuaries. Admittedly, criticisms have sometimes been off the mark, and they often seem naive. But let us strive to view such criticism with the open-mindedness expressed by Winston Churchill, who said:

"I do not resent criticism, even when for the sake of emphasis it parts for the time with reality."

The "concerns" from within our profession have perhaps been slower in coming, but they now abound, to be sure. The actuarial leadership felt it necessary to appoint this Committee, either to successfully silence our critics or allay our own concerns; probably they had both in mind. Since our appointment, there seem to be many actuaries who feel we need something to improve the way we handle dividends. Certainly the Committee feels that way.

The criticisms and concerns fall into these six general categories:

1. Are illustrated dividends used in cost comparisons consistently determined and under adequate control so as to validate such comparisons?

Here have been raised two essentially different points. The first: since they are not guaranteed, should they be mixed with streams of guaranteed cash flow? If so, how? The second: if dividends are used in comparative costs, then they must be determined on comparable bases. Here is where much of the controversy about use of the investment year method rests, if not by our critics then at least by the "concerners" in the profession.

2. What is an illustrated dividend? Is it a projection? A prediction? Many apparently believe it is, if their choice of words is intentional and not merely a loose use of the language. Should it be? Some, even within our own profession, have advocated that it should be a prediction. But it is not "merely" an illustration? And what is that?
3. What is the illustrated dividend based on -- current experience? What is that? And do all actuaries use that, defined consistently? There is evidence that they do not, and that has been a cause for concern.
4. Does the public understand what dividends are? Or are not? They do not seem to. Certainly the critics and consumer advisers miss the mark quite often. Before they can be expected to have a correct understanding, perhaps a better understanding should be developed among the life insurance agents and others in the industry. And before that occurs, it seems to many that a clearer agreement must be reached within the actuarial profession.

5. To use terms that the press has used to describe our dividend-setting process, is the actuary guilty of "manipulating, tinkering and rigging" dividends? This thinking seems often closely linked to the faulty syllogism stated earlier. But then again, are we?
6. Are there adequate guidelines in actuarial literature to well serve the actuary in this important aspect of his or her job? Many, including our Committee, believe not, and that is the basis for most of our concern. It is with hope that we also believe that therein lies the potential solution to our difficulties and the various criticisms and concerns that have been expressed.

Before we came to the point of suggesting we should now pursue well developed and articulated guidelines, however, the Committee worked at several statistical tests that were initially thought to be helpful. Mr. Garber will share some of that process with us.

MR. HARRY D. GARBER: One of the fundamental questions addressed by the Committee was the basis of dividend illustrations. We concluded that illustrations should be based on current company performance, as, of course, are the dividends being paid on business in force.

With illustrations and current dividend payments based on the same essential body of experience, and most companies follow this practice, it should be possible to develop statistical tests to assure the general conformity of dividend illustrations and dividend payments, and the Committee sought to establish a fair and appropriate means of doing just that. Although different methods were developed and tested extensively, the effort, in the end, was not successful. I will attempt to describe briefly the several approaches tested and the reasons for the failure of this effort.

There are two basic approaches that can be used in assuring the general conformity of illustrations and current paid dividends. The first is to require that the dividends illustrated by a company on new business should be determined by adjusting the dividends being paid on otherwise similar in force policies for differences in premium and benefit structures. The second approach is to compare the net costs currently being illustrated with the net costs on otherwise similar in force policies and to determine whether the differences, if any, fall in an acceptable range. We started with this second approach because if, in fact, the net costs being illustrated on new issues are comparable to the net costs on existing business, it would be unnecessary to require development of illustrative dividends by adjustment of dividend scales on business in force.

Those of you who are responsible for dividend scale development can, if you think much about it, readily appreciate how much conceptual difficulty is encompassed in the rather simple phrase, "otherwise similar policy." For example, in determining the net cost per \$1,000, is a \$40,000 whole life policy similar to a \$43,000 whole life policy? What about a \$60,000 policy? Is a current policy in which full credibility is given to the observed differences between male and female mortality similar to one issued several years back in which less credibility was given to these differences? Can there be any otherwise similar policies if significant changes in underwriting standards have been incorporated in the pricing structure of the current series? These and many similar questions would make the construction of a full scale statistical test a very difficult proposition.

Our tests were considerably short of the full scope that would be required to assure any defined degree of conformity between illustrated and paid dividends. Yet they fully demonstrated, we believe, the inherent problems with this approach in the present environment. In our tests we asked several of the companies represented on the Committee to submit comparisons of (1) net costs being illustrated and (2) net costs on in force business for three policy sizes (\$10,000, \$20,000 and \$40,000), two ages (25 and 45) and two plans (whole life and five-year renewable term). The comparisons were made on two bases: first, with the current year net costs actually experienced in 1977 for a corresponding policy issued in each of the last 20 years; and second, with the net costs in the current year and through the twentieth policy year (if the current dividend scale is not changed) for a corresponding policy issued in 1972, 1967 and 1962.

The results are illustrated in the Committee's report. In general, these tests indicated cost differences between illustrated and in force business that were larger and less predictable than had been anticipated. We then sought detailed explanation of the larger differences observed. The explanations proved to be complex, reasonable and to fall well within the latitude traditionally extended to companies in pricing and dividend matters. There was little, if anything, that would cause the "lifting of professional eyebrows," and yet, in the aggregate these actions had produced some sizeable differences between the costs on old and new business.

The essential problem is that, with the data and analytical tools now available and without the constraint of professional guidelines, the actuary can develop, justify and implement more and more refinements of the pricing process. For important practical and philosophical reasons, these refinements are seldom applied to existing business and, therefore, discontinuities between the costs on new and old business are frequent and, sometimes, sizeable. As the tables in the report suggest, however, changes in pricing practices are not always uni-directional. That is, such changes often do not involve reducing prices on new business across the board but, rather, a different approach which increases prices in some areas and reduces prices in others.

Without professional opinions and guidelines, the Committee has no foundation on which to base any recommendations as to an appropriate relationship between the net costs on new business and the costs on existing business. And, in these circumstances, the Committee believes that the first order of business is the establishment of professional opinions and guidelines with respect to the setting of the dividend scale, including the scale of illustration dividends. Once a set of such opinions and guidelines is firmly in place, we may well find it possible to design statistical tests to measure conformity of the illustrative and paid dividend scales to the established professional opinions and guidelines; without them, there are no standards against which to make such measurements.

If the existing differences between the costs being illustrated and those being experienced on business in force are not modest and insignificant, should we seek to discipline dividend illustrations by requiring that such illustrations be developed by adjustment of dividends on otherwise similar existing business for differences in premium and benefit structure?

We looked at this possibility quite closely and concluded that this course is also inappropriate. The buyer will be interested in illustrations based on the pricing structure which will be applied in future dividends. In the absence of professional guidelines, the Committee concluded that it is virtually impossible to develop an adjustment process that will permit recognition of important changes in pricing practices but, at the same time, retain the financial discipline of the present dividend scale.

MR. THOMAS C. SUTTON: The failure of the mechanical or statistical type tests which the Committee has explored can be viewed in a positive light, and it confirms what many might have believed to start with - that dividend determination involves many judgmental matters within the peculiar purview of the actuary and these matters cannot be set in concrete nor readily codified. This conclusion, however, should not lead to inaction and complacency. Instead, it suggests that we take actions designed firstly to support and strengthen the professionalism of those judgments and secondly to secure a broader recognition of this exercise of actuarial professionalism. Those are the objectives which the Committee intends to pursue in the future.

This path is not a new one. Much has been said and written over the last few years concerning professional responsibilities, statements of generally accepted practice and other related topics. In particular, the Society's Committee on Pensions has traveled this road up and down. Many of the alternatives they considered, the arguments for and against, and the general lines of thought can well be applied, with slight modifications, to the task we have at hand.

Without detailing this background, I'd like to skip ahead and briefly sketch the elements of one alternative. This alternative is not intended to represent a Committee recommendation at all--it does, however, encompass a number of items which have had discussion in the Committee, and which, of course, will receive further attention in the future.

The basic element would be an opinion as to Professional Conduct on Actuarial Principles and Practices in Connection with Dividend Calculations and Illustrations. This Opinion would be relatively brief and include general statements of broad content, setting the stage for the next element consisting of more detailed recommendations. Two sample Opinions were included in the Committee's interim report.

The recommendations would be analagous at least in form, detail and length to those on the subjects of Financial Reporting, and Pension Plans. Further, there might be several distinct recommendations.

The first would be on Principles and Practices - this would be the longest and the outline of contents would perhaps be similar to that of a text on the subject. It would certainly include discussions of equity, dividend classes, the calculation methods in common use, each experience factor and its effect on the computation, and so on.

A second recommendation would be on Actuarial Reports and Statements of Opinion. This recommendation pre-supposes some legislative background requiring, for example, that the Annual Statement be accompanied by (1) an Actuarial Report and by (2) a Statement of Opinion. The Actuarial Report would provide a description of the company's dividend scale, perhaps as a part of Schedule M. The Statement of Opinion would address calculation methods and results for dividends paid and illustrated, to be signed by a qualified actuary. The function of the recommendation thus would be to

provide the suggested form and content for such disclosure.

Other recommendations would be directed toward more specific problems such as investment generation methods, cost comparison methods, or participating insurance sold by stock companies.

Thus this alternative includes:

1. an extension of the Guides to Conduct which would document and support professionalism, and
2. a legislated recognition of the exercise of that professionalism.

MR. DALE R. GUSTAFSON: First, the interim report is, in my opinion, a first-class piece of work. This is indeed a most difficult and elusive area and I think the Committee has done a remarkable job of steering a sound course. I strongly support the direction they are now headed in, that is, of disclosure. It is on the historical frame of reference of disclosure of dividend practices that I wish to comment briefly.

In the 1930's and for some time before that, it was the practice of most mutual life insurance companies to publish all of the details of their dividend formulas in the annual statement. However, with the advent of mechanical data processing, and then later electronic data processing, it became possible to make the formulas more complicated and sophisticated to better achieve equity.

With this development, full disclosure of the dividend formulas was abandoned in the interests of practicality. It was just too burdensome and complex to set down all of those details in the annual statement. Thus, for a while, summaries or abbreviated descriptions were published.

Then, even these abbreviated descriptions were abandoned and sample dividends were published in the annual statement, and that practice now continues in the form of Schedule M. This development was largely motivated by a genuine desire to provide as much disclosure as was reasonably possible. It was recognized that the summary and abbreviated formulas didn't really say anything effective, and it was further thought that the kind of array represented by Schedule M would give adequate disclosure.

Gradually, over the past several decades, an atmosphere of secrecy has developed around dividend practices. It is my personal opinion that this has not been a healthy development, and I am greatly encouraged by the direction the Society's Committee deliberations is now taking.

In closing, I would like to read a brief paragraph from the Armstrong Committee Report that came out of the investigation of the life insurance industry by the New York Insurance Department in 1906. These words are clear and unequivocal and I believe accurately reflect the attitudes and understandings of that day. I am not aware of any statutory or regulatory developments since then that should have changed these attitudes and understandings:

"In connection with the provision requiring annual distribution of dividends upon policies hereafter written, the companies should be required annually to file with the Superintendent of Insurance a gain and loss exhibit for the year in a prescribed form, showing with suitable detail the gains and losses of the year, the amount available for distribution, the amount of dividends declared, and the method of calculation by which they have been determined.

"The Committee has not thought it advisable to recommend that the Legislature should establish the manner in which dividends should be computed. If the companies are required to state their methods of computation ample opportunity will be afforded for a comparison both of methods and results, and any method which is open to serious criticism can readily be reviewed in the courts." (Emphasis added)

MR. ERNEST J. MOORHEAD: This discussion speaks only to the question of dividend illustrations because I regard that as far more urgent than the problems in dividend apportionment. Unless our profession promptly sets forth ground rules permitting uniformity in illustrations, we will hand our long-enjoyed initiative to the regulators.

Count me among those who are disappointed with the interim report. More than three years ago the Munson Committee clearly showed that actuaries are constructing dividend illustrations with deplorable lack of uniformity. By this time we should have been able at least to narrow that diversity.

The present committee's difficulty in providing the much-needed leadership appears to be due to a combination of causes that I shall try to enumerate.

1. The section of its report entitled "Basis of Dividend Illustrations" seems to mis-describe the nature of the creature with which we are dealing. Illustrations are depicted as being purely informational figures for buyers; it would be healthier to identify them as primarily sales aids aimed at showing the company's product in a favorable competitive light. When illustrations are recognized as marketing instruments the principle (page 4) that "requirements....should be aimed primarily at disclosure rather than at restriction of practice" can easily be seen to be unworkable. Uniformity, not just disclosure, is essential for illustrations.
2. The stated objections to tying illustrations to dividends now being paid seem lamentably weak. I fail to see why defining uniform practices for illustrations (page 9) constrains the dividend apportionment process. And surely uniformity need not be ruled out on the grounds that actuaries who are out of step with widely accepted procedure "have reasons which they are willing to support". Of course they have!
3. On page 11 it is said that the mathematical adjustments needed to tie illustrations to current dividends would not be comprehended by buyers and regulators. Why do buyers need to understand these adjustments? Is an actuary incapable of understanding them just because he or she happens to be a regulator?
4. The committee's concern that "reconciling paid and illustrated dividends by some statistical process....cannot easily be used as the basis for enforcing discipline in the dividend illustration process" seems to be interfering with getting the immediate and urgent job done. The overriding problem is that actuaries have not been provided with a recommended uniform approach to constructing illustrations. As soon as such has been formulated and has been accepted by consensus it is to be presumed that actuaries will conform. At the moment actuaries have nothing to which they can conform.

For all these reasons I urge that the Committee promptly choose the best solution it sees to the problem of uniformity in illustrations and announce that solution to our members. Nothing in the report disqualifies the solution stated in the second paragraph of page 8 from being the one to be offered.

MR. THOMAS F. EASON: There is in the United States a substantial volume of dividend paying life insurance business which has been sold by stock companies. Dividend practices for this business are diverse as recognized by the American Institute of Certified Public Accountants in Audits of Stock Life Insurance Companies. This audit guide outlines certain earnings limitations which affect dividends and refers also to "companies for which there are no earnings restrictions and who use dividend scales that may be unrelated to actual earnings."

Regulatory actuaries and many practicing consultants are witness to the neglect or abuse of consistent dividend practices in this segment of the industry. Companies involved often began as promoter-oriented enterprises. (Background is available from various references relating to "Special Policies including Halsey Josephson's book, The Case Against New Life Insurance Companies). Many millions of insurance are still in force on their policies which have participating (sometimes called "profit-sharing") provisions. Over the years, a number of insurance departments have struggled with equity questions arising from the dividend scales on such business.

A very few states approach these questions by requiring a separation of accounts between participating and non-participating business. These requirements are not rigorously administered and appear to have limited impact. Other dimensions of the problem are explored in Joseph Belth's book, Participating Life Insurance Sold by Stock Companies.

The insurance department examiners have something of a lever in the standard N.A.I.C. examination procedures. These include a review of company practices and of the equity of policyholder dividends. Departments have done rather little with this, perhaps because of the technical difficulty in evaluating the actuarial aspects. Typical Reports of Examination issued by the states contain only limited descriptive information on dividends. Real scrutiny of company practices in this area is seldom indicated.

I suggest that the Matz Committee review, in addition to Schedule M of the Annual Statement, both the examination processes involving dividends and the advisability of expanding the separation of accounts approach. Regulatory improvements in these areas can have substantial positive effect if promulgated intelligently and applied skillfully. Hopefully recommendations in this area may be made by the Committee as part of its findings on practical dividend problems.

Having discussed specific regulatory activities, I turn now, briefly, to a general interest topic -- regulators. Updated reporting requirements and examination procedures are not enough to improve dividend practices or the quality of regulatory review. The regulatory processes which evolve in the years ahead will be no better than the department personnel who interpret the Society's recommendations and subsequently administer state requirements. Government may be expected to assume a larger role in monitoring and, perhaps, even mandating dividend practices. While research continues, we should seek to strengthen the actuarial resources of the regulators. We may then elevate our discussion with the states (or other entities) to the benefit of the private insurance business and its policyholders.

MR. JOHN C. MAYNARD: The Committee on Dividend Philosophy has been seeking a standard method of making dividend illustrations in such a way that the illustrations are consistent with dividends being paid. One method would be to construct a dividend scale for illustrations on new policies such that the scale would be the one in effect if these new policies had been in force for ten years. Judgment would be required to construct the scale because new policies will probably differ from policies actually issued ten years previously. The actuary could be made responsible for this judgment and might be asked to file a report on the construction of the scale with a professional committee. The reason for choosing a period in force, such as ten years, is to minimize differences between companies which allocate interest differently by year of issue.

MR. J. ALAN LAUER: A previous speaker has pointed out the tendency today for companies to give rather vague descriptions of their dividend scales in Schedule M of the annual statement. He also mentioned that many years ago descriptions of dividend scales in the annual statement tended to be very complete. This situation is more understandable if one recognizes the increasing complexity of dividend scales. In the 1930's, the Trustees of my company approved dividend scales which could be described completely on one 8.5" x 11" piece of paper. Currently, the Trustees approve a dividend scale that is described in a booklet of over 100 pages. It is rather frustrating to try to summarize this 100 page booklet in Schedule M, and hence the tendency to vagueness.

While this tendency is understandable, it is unfortunate. This situation has contributed to the cloud of secrecy that has grown around the dividend apportionment process. If we do not do something to remove this cloud of secrecy, regulators and outsiders are likely to do it in a manner that we may find objectionable. The industry, and the Society, should attempt to find meaningful and useful methods of disclosure of the dividend apportionment process. The big question is what is a meaningful and useful method of disclosure, and I hope that the Matz Committee will continue to address itself to this most difficult question.

MR. JOHN R. McCLELLAND: A previous speaker has mentioned that dividend formulas should not be kept secret. While that position may receive substantial support from actuaries, I would like to caution you that the managements of many life insurance companies may not agree. Since we are talking about a matter that involves broad corporate considerations, we should avoid giving the impression that all actuaries agree that the dividend formula should be available to policyholders.

MR. JOHN C. ANGLE: I compliment the Committee on Dividend Philosophy on their first report and the principles enunciated in that report. I say this even though the prospect of guidelines always causes me worry. This is because of my concern that guidelines may stifle our Socratic tradition of freely criticizing all received Truth. Beyond this reservation, I suggest that the Committee bear in mind that the need for disclosure guidelines has been created by decline in the caliber of state supervision, by the businessman's customary fear of the press and by the usual difficulties of the specialist in communicating with the public.

The persistent difficulties faced by state supervisory authorities in the United States in hiring actuarial staffs are well known. Few states employ members of this Society and even fewer are able to assign FSA's to review dividend distributions as part of company examinations. As a result few NAIC examination reports, especially those covering insurers not operating in New York State, adequately describe the details of the dividend formulas of the insurers under examination. Compounding the inadequacy of disclosure in Convention Examination Reports is the snail-like pace at which the whole examination procedure takes place.

The Committee could make a worthwhile contribution to fuller disclosure of dividend practices by critically reviewing a representative sample of NAIC examination reports. Such a review would make it possible to highlight present deficiencies and to recommend remedies to the National Association of Insurance Commissioners.

Because the examination system is not working as a means of disclosure, we observe the rise of the Gadfly press as a substitute. The best known is a newsletter published by Professor Joseph Belth as The Insurance Forum. A common reaction of actuaries to Professor Belth's inquiries seems to be that silence is golden. However, such a reaction raises quite unnecessary suspicions that something is being hidden from the public.

It may embolden others to respond candidly to Professor Belth if I briefly recite my own experience in dealing with the Professor. He wrote in the spring of 1977 after the Guardian advertised its sixth consecutive increase in dividend scale in the pages of the Wall Street Journal and Newsweek. The ad represented dividends projected for a 35-year-old purchaser of a whole life policy in 1957 and contrasted the projection with the history of dividends actually paid. Professor Belth requested the Guardian's applicable dividend formula, the factors projected for the 20th policy year and the factors actually used in 1977.

We responded, Professor Belth later wrote, "promptly and thoroughly." From our view, the resulting article in the August, 1977 issue of The Insurance Forum was a fair, balanced treatment of our action. Professor Belth used the information with care and presented it strictly within context.

I close by remarking that specialists in all disciplines share the problem of explaining technical work to the general public. Each of us must in the end hammer away at the problem by working to improve our own expository skills. The place to begin, however, is not with the press or the Congress but where you work. Make certain that you fully explain all dividend proposals in terms that non-specialists can readily grasp. And don't overlook the members of your Board of Directors. Make certain that all implicit and explicit assumptions, both strong and weak, are fully communicated to these important representatives of the general public.

MR. CHARLES GREELEY: The Committee on Dividend Philosophy is to be congratulated on its thoughtful and stimulating interim report. The report makes one appreciate the complexity of the problems in the dividend area and the non-existence of easy solutions. The continuing work by this Committee should bring some order into this very sensitive area.

In general, I agree with the thrust and direction that the Committee has taken. Their report makes it quite clear that the major problem lies in the area of dividend illustrations. I agree completely with their conclusion that the "current scale" basis for illustrating dividends is better than an "historical" or a "projected" basis. The report has also convinced me of the futility of statistical tests involving comparisons between illustrative dividends for new sales and current payable dividends at the same durations on existing (and therefore different generations of) policies. I also agree with the desirability of achieving future improvements through more disclosure, through the establishment of "Guides and Opinions", and through such other steps as may be necessary to promote the highest professionalism on the part of actuaries.

There is some indication in the report that the proposed remedies should apply in part, to payable dividends. It seems to me that there is nothing seriously wrong in the "payable dividends" area as it now exists. There would appear to be no intrinsic reason for a company to favor, for example, a 3-year old policy over a 30-year old policy in the process of developing payable dividends. There is certainly no sales advantage since both policies are already on the books, and hence an actuary can develop an equitable apportionment with relatively few extraneous pressures which might influence him.

However, the method of developing "payable dividends" is of prime importance insofar as it spills over to "illustrative dividends". In my opinion, this is the crux of the matter: any decision affecting the carrot of higher illustrative dividends (and hence improved competitive costs) should carry with it the stick of correspondingly higher out-of-pocket payments for dividends on inforce policies.

This matter of financial discipline is alluded to in the Committee's report. For example, they rejected - quite properly, I believe - the concept of "projected dividends" as an illustration basis because no financial discipline at all would then exist. But, even accepting the "current scale" basis for illustrations, there are still problems - in varying degrees - if the needed discipline is to work to best advantage. Perhaps the following examples will illustrate what I have in mind.

1. Expense Considerations:

The report gives a good example of the increase in the average-size policy and its effect on unit expenses. The particular example involved a term policy issued for an average size of \$14,000 in 1962 and \$28,000 in 1977. When the dividend scale was being set for the later series of policies, the actuary had to take a guess at just what the average size would turn out to be. Aside from actuarial integrity, what would prevent him from guessing \$38,000, \$48,000, or even more? The higher his estimate, the better would be the illustrated cost for new issues - without costing his company a single penny in dividends currently payable. Hence, there is no financial discipline here.

Of course, in this average-size example, it would not be long before actual data became available to force a correction of a wildly optimistic estimate. But, there are many other areas in expense allocations which would not be subject to so accurate a check.

2. Mortality Considerations:

A better example of a lack of financial discipline might come from estimates of the mortality to be experienced under a new series, for example, one for a higher minimum amount than had previously applied. The actuary here might guess significantly improved mortality levels and hence illustrate better long-term costs. As experience evolved, payable dividends would reflect the true mortality levels - but it would be many years before the full effect would be felt. Again, the optimistic estimate carries no immediate financial penalty to the company.

3. Interest Considerations:

In the matter of the interest rate used in dividend scale calculations, let us first consider a company using a portfolio rate basis. Let us also assume that its actuaries are trying to decide between a $5\frac{3}{4}\%$ and a 6% interest rate for their next year's scale - under the portfolio basis, such rate would be used for payable dividends on all existing life insurance policies and for illustrative dividends on new business as well. If the reserves of the company are one billion dollars, a decision to adopt the 6% rate (rather than the $5\frac{3}{4}\%$ rate) would carry with it an immediate extra cost of about $\$2\frac{1}{2}$ million in dividends payable during the coming year on the existing business. The decision would, at the same time, have a favorable impact for new sales - perhaps reducing the 20-year interest-adjusted index for a particular policy from $\$4.20$ under a $5\frac{3}{4}\%$ interest rate to $\$3.80$ using the 6% rate in dividend calculations. Thus, if the actuary is optimistic in his view of the interest economy and if he feels his company's surplus position and earnings are on the upswing, he might opt for using the 6% rate - distributing an extra $\$2\frac{1}{2}$ million with the compensating reward of a 40¢ per $\$1,000$ improvement in illustrative cost indexes. He can be optimistic with his promise as long as he is correspondingly optimistic in his deeds; but it would not be possible for him to be optimistic with his mouth and pessimistic with his wallet.

Now take a company that is using the investment-year method for determining the interest rate used in its dividend calculations. There is no similar financial discipline for the actuary in this case, as there was for his counterpart in the company using a portfolio interest rate method. For example, the investment-year actuary might be trying to decide between a $6\frac{3}{4}\%$ and a 7% interest rate for his company's most recent investment class -

which would be the one used for illustration purposes. If his company also had one billion dollars of reserves, it is likely that the most recent investment class would represent at most 10% of the total business. A choice of the 7% rate for illustrative dividends would then cost the company only an additional \$250,000 in payable dividends, rather than the \$2½ million price tag for the portfolio interest rate method. The actuary's decision on the interest rate basis for his older investment classes can be quite separate and unrelated to his choice for the latest class - he might decide to use conservative rates on the older classes (for example, decide on 4 3/4% rather than 5% on some very old class). In effect, this actuary can be optimistic with his promises and pessimistic with his wallet - except for the petty change required for his latest investment class.

In the light of the hypothetical cases described in 3 above, it seems clear to me that the full weight of financial discipline guides the actuary whose company follows the portfolio interest rate method; while only a small portion of the weight (10% in my example) falls on the shoulders of the actuary whose company follows the investment-year method. Pending some other solution that may yet be found in the future, the second actuary must bear the responsibility for living up to the spirit and intent of the Committee's eventual Guidelines and Opinions.

Proponents of the investment-year method for calculating life insurance dividends may well ask why actuarial integrity is more significant with respect to interest rate determinations than in the other areas of expense and mortality considerations. I would give two reasons - both practical ones. The first is a matter of degree: variation in interest earnings have the greatest impact on dividends, and hence on competitive costs, at the present time. The second reason is that you rely upon integrity if you have nothing else to rely upon; but, when you do have something better (such as the full financial discipline inherent in the portfolio interest rate method), a decision not to use it carries a special responsibility.

To be blunt about it, the main problem in the illustrative dividend area comes about when a sale is made on the basis of competitive price. It is desirable to increase consistency among companies with respect to the methods of illustrating future costs - without dictating by fiat what dividends they may pay. Complete consistency in illustration can never be obtained because of the complex nature of participating life insurance, but we should certainly go as far in the right direction as is feasible. The Committee's recommendations for Guidelines and Opinions are a good step in this direction - and one I fully support. I would hope they single out those areas where financial discipline may be lacking for special attention, and provide stringent standards for the higher degree of professional responsibility.

MR. HAROLD G. INGRAHAM: If the life insurance industry is to ever achieve a greater degree of comparability in dividend illustrations, whether through disclosure alone or through mandated dividend apportionment methods as well, attention cannot be riveted solely on the dividend investment component.

To single out that one item of a dividend scale will not necessarily produce any more comparability, since a company could choose very cynically to calculate a dividend scale using "investment year method" interest analysis, then produce a dividend investment component for that scale using a "portfolio" approach, and finally derive the expense amortization pattern which would reproduce the previously-calculated result.

Thus, there could be two companies using radically different interest allocation philosophies, with different expectations of future dividend changes, displaying apparently fully comparable dividend illustrations.

