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DIVIDEND PHILOSOPHY

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1. The appropriate basis of dividend illustrations.

2. The professional responsibility of the actuary in the establishment of dividend scales and in dividend illustration practices.

3. The need for professional opinions and guidelines concerning policyholder dividends and illustrations.

4. The adequacy of the recommendations of the Committee on Dividend Philosophy in addressing current concerns.

5. Differences between the approach of the Committee on Dividend Philosophy and the traditional approaches (e.g., the concept of dividend class).

6. The development of dividends for participating products in stock companies.

MR. HARRY D. GARBER: There has been immense interest for at least the past ten years on the subject of dividends and dividend illustrations in particular. There have been a number of committees that have been formed to deal with this, some from the industry, some professional. Each has added importantly to our knowledge of dividend practices and illustrations.

About two and one-half years ago the Society appointed a Committee on Dividend Philosophy with the following charge:

> The purpose of this committee is (1) to study in depth the underlying actuarial principles and practical problems relating to the calculation and illustration of dividends, including related matters of philosophy, and (2) to develop a report on its findings and recommendations.

The discussion today will be based on the Report of the Committee on Dividend Philosophy, and on two papers -- "Choice of Basis of Dividend Illustrations," by Russell R. Jensen, and "Philosophic Issues in Dividend Distribution," by Robert C. Winters.

MR. RUSSELL R. JENSEN: There are two aspects to life insurance dividends: paying them, and illustrating them. We find, of course, that these two aspects are hard to separate. You might say that the main conclusion of the paper "Choice of Basis of Dividend Illustrations" is that the closer the connection between paying and illustrating, the better. Or, to paraphrase contemporary vernacular, "What you see is what you get."

We do, however, find choices when we search for bases of illustrating dividends. We can show past experience. These are dividend histories, and were the original basis of illustration back around 1900.

We can show what we are currently paying -- and if we are still issuing the same contracts and paying the same scale as a number of years ago, this is a dividend history.

What if we want to illustrate more years, or if contracts offered for sale today are different from those offered years ago? We move to the concept of current experience, which must underlie the dividends currently being paid on older contracts. But what if there is no actual experience on the policy being issued, and its cost characteristics are very sure to be different from those of policies now in force? New questions arise as to what "current experience" means under such circumstances.

Another logical consideration for the basis of dividend illustrations is an active, intentional forecast. Despite the conventional language often used with illustrations, that they are "neither a guarantee nor an estimate" of future results, they very often are referred to as "projections" and often interpreted as forecasts. Indeed an illustration based on current experience _is_ a forecast -- on the premise that the forecast is that current experience will not change.

If those are the main choices -- past payment record, current payment or current experience, and forecasts -- under what criteria should the choice of basis of illustration be made? I have listed six purposes of dividend illustrations:

1. To give a representation of the dividends, which provide the essential means of carrying out the purpose of the participating contract.

2. To give an indication of the cost of a participating contract on a basis other than the most adverse.

3. To show a past record.

4. To reflect current company performance.

5. To permit comparisons.

6. To forecast future dividends.

From these purposes we can reduce three principal criteria:

1. Facilitation of buyer comparisons.

2. Reflection of actual performance.

3. Likelihood of fulfillment.

With a little study, we find that not all of these can be totally and simultaneously achieved. Nonetheless, they are the main considerations in analyzing the possible choices, and in the end some balance must be struck.

It is not surprising that circa 1900, the choice was past dividend histories. That was an era of slower change in policy forms, rates and values. It is not surprising either, that this soon evolved to a basis of current actual payment, or to the current experience which underlies current actual payment.

Active intentional forecasts have been avoided. As a practical matter, it would be very difficult to demonstrate with a forecast that there was a close connection between a company's forecast and its actual performance. Also it would be difficult to maintain comparability between dividend illustrations with uncontrolled forecasts, and if the forecasts are controlled, performance reflection suffers. Finally, do we really expect in this day and age that if forecasts were allowed they would be uncontrolled? Then, given a choice between current experience and a forecast under regulatory control -- what would you have?

My choice is clear: current actual payment, where available, and after that the current experience which underlies it. This reflects the insurance company's actual performance. It affords a good basis of comparison. It may even be a better forecast than <u>some</u> active, intentional forecasts. In any case, a change in future dividend payments can be explained in terms of changes of actual cost factors. I would rather undertake that explanation than one in terms of a future which proves to be different from the forecast -- or possibly have no explanation at all. Perhaps the most forceful reason of all for a current payment or experience basis is simply this: it provides an effective discipline on illustrations. With this basis, at least one cannot illustrate or suggest what one cannot currently do. Or to paraphrase the vernacular again, we ought to put our mouth where our money is.

This still leaves quite a bit for further study, discussion and articulation. I will mention three areas in this introductory comment.

First, current experience can be an illusive term in some circumstances. That needs more attention by our profession. The relationships to current dividend payment need to be explored, as part of further study on current dividend payments themselves.

Second, since "what goes up must come down" probably applies to interest rates and therefore to life insurance dividends, we have an interesting problem in our future. Should we continue to illustrate current experience when the day arrives in which it is clear that interest rates are headed significantly downward as part of a long-term cycle? If not, what are we to do? Or say?

Which brings me to a favorite as the final point. For too long we have been telling buyers what dividend illustrations are not: a guarantee or estimate of future results. We ought to tell them simply, understandably and effectively what they are. Namely, that illustrated dividends reflect current claim, expense and investment experience, and that they will change in the future as claim, expense and investment experience changes.

MR. THOMAS C. SUTTON: With the background and considerations that Russ has presented in his paper, the conclusion he reaches on the choice of an appropriate basis for dividend illustrations seems quite natural. The Committee on Dividend Philosophy, as indicated in our Interim Report last year, reached that same conclusion -- which might be rephrased this way:

> "The calculation of illustrated dividends should be firmly anchored to dividends currently allocated."

This stated principle has an air of substance and solidity, and superficially at least, it is quite satisfying. However, upon examination several questions come to mind:

- How do we know there is solid ground for the anchor to grab?

- What do we mean by solidly anchored?

- Who does the anchoring?

- How can others be reassured that the anchor is solid and that the ship won't float away?

Some of the concern implied by these questions centers around an uneasy feeling that the concept of dividend illustrations based on current dividend scales may not be as rigidly defined and free of abuse as we once may have thought. This concern, at least in part, flows from increased emphasis on price comparisons. Acknowledging these difficulties, the Committee examined the possibility of better definition and improved discipline in applying the current allocation approach.

The initial set of attempts along this line concentrated on developing an objective, statistical method of relating illustrated dividends to those that are paid. If these attempts had been successful, then the anchoring process would have been explicitly defined, almost anyone (with a computer) could have secured the anchor, and anyone else needing reassurance could have checked it. However, in analyzing various methods, it became evident that any statistical comparison would have to allow wide discrepanies if it were to accommodate all legitimate differences, and it seemed probable that some potential not-so-legitimate differences could fall within the same bounds. That is to say, if the anchor chain is too long, the anchor serves no purpose. On the other hand, to pull in even tighter on the chain, as there might be pressure to do, would eventually result either in dislodging the anchor or sinking the ship. By sinking the ship I mean forcing such stringent apparent consistency between illustrated and paid dividends that the actual differences in characteristics between new and old business are submerged. In any case, these problems resulted in abandoning the statistical approach.

The Committee's focus of attention then moved from the process itself to the person who performs it - the actuary - whose judgments play the leading role in dividend determination. It was soon concluded that the best course of action was not to discard professional judgments, but to channel them, with better definition and greater discipline. This led to three basic initial steps:

> First, to develop statements of principles which would define the anchoring process and the ground to which the anchor was secured; second, to incorporate such statements in professional Guides to Conduct, thus clearly identifying who is responsible for this process; and third, to propose to the proper authorities that an actuarial certificate in these matters be included in the Annual Statement.

Clearly, the most difficult of these to accomplish is to develop statements of principle. As the current Committee Report indicates, "... words become slippery. Two individuals may agree on a statement of principle only because they interpret the statement in two different senses." To the extent this occurs, the objective of better definition has not been achieved and the value of any certificate is lessened. Therefore, the Committee feels that such statements of principle must be augmented by extensive exposition of the way such principles would apply. However, the presentation of such detailed elaborations would be premature prior to general agreement among the profession concerning the broader principles -- and that, in part, is why we're here today -- to generate the consideration and discussion of those general principles.

MR. ROBERT C. WINTERS: My paper grew out of a session on dividend philosophy at the New Orleans Conference a half a dozen years ago. I was recruited to summarize what had happened in a study note for actuarial students. The study note was deficient in respect of the participating business of stock life insurance companies. The Education and Examination Committee felt that one way to try to remedy that deficiency might be to publish it and solicit discussions in that area as well as, of course, in the area of mutual practice.

The paper is a recasting of the study note and is intended as a state of the art summary of where we are and how we got there. It invites comment from people who either don't think that is where we are or don't think that is how we got here or who otherwise would like to elaborate on the material which is there. It undertakes to avoid advocacy of any position which is appropriate in view of its background. I would certainly welcome any additions to the paper recognizing that a key focus is the students of the future.

MR. GARBER: I have some questions for our panel which may elicit further comments. First, Russ, a perplexing aspect of dividend illustrations is that what we believe dividend illustrations are and should be, is not reciprocated by what the public normally understands them to be.

MR. JENSEN: Does the public understand what a dividend illustrations is? In general, no, although they may have in particular cases more of an understanding than we might give them credit for. They can understand the concept of current experience, and we should work on getting that across. We ought to have better dividend explanations, and we ought to be more active with our sales representatives in teaching them what dividend illustrations are. I think that people would understand that these illustrations are based on current operating conditions and that if those conditions change, then their dividends will change.

MR. GARBER: Are you going to actually put some language in your illustrations that will try and work to that effect?

MR. JENSEN: Yes, we will. Next year we will have a better and clearer dividend explanation.

MR. SUTTON: I would reinforce the importance of having the education process start with the agents and field people.

MR. GARBER: The Committee spent considerable time in looking at the question of the investment year method and how that complicates the comparison process. Russ, would you describe this issue and then perhaps either you or Tom could discuss why the Committee's recommendations do not deal specifically with it.

MR. JENSEN: I would say that a portfolio illustration and an IYM illustration are not comparable and that's the basic problem. An illustration based on current experience is by its nature of static character and of course in real life things are dynamic. Under the investment year method if all future dividends are shown using the current new money rate there is an implicit treatment of the dynamics that would have the present new money rate continue forever. In contrast under a portfolio approach the implicit treatment would be that the new money rate moves immediately to the portfolio rate and remains at that level. Those two results are not comparable, and therein lies the problem. One can disclose to people the basis you are using but its hard to see how comparisons between the two bases can be made.

MR. SUTTON: I can certainly sympathize with the problem of non-comparability, but this is a fine example of an area in which words become slippery and the exact meaning of "current experience" becomes important. In one sense you may view equating current experience with the portfolio rate as a static illustration. However, at a given time if the new money rate is above the portfolio rate it is in a sense automatically going to carry the portfolio rate higher and higher. In that sense the illustration could be viewed as not static. It depends on your prospective, but I think that most people would agree that the two bases are essentially different. The least we can do is to point out to people that there are these two different bases and to try to go some distance with disclosure.

As far as the Committee trying to specifically address in the opinion the issue of new money versus the portfolio approach, I think that the concept of the interest basis is in a sense a detail. It may be a very important detail -- one that's caused a great deal of controversy and one that may have in part contributed to the formation of the Committee -- but, nevertheless, to single that out as opposed to other elements for which there also may be quite a variety of practice did not seem appropriate as part of a basic first step. It should certainly be a part of subsequent steps.

MR. GARBER: Tom another thing that the Committee dealt with only in part is the participating business of stock companies. Would you describe for us what happened there?

MR. SUTTON: The more thought that was given to some of these matters, the more elusive they became, so that it became necessary to isolate some of the concepts to the most traditional form of application. For example, we started out with individual insurance as being the main focus. The basic philosophy that underlies mutual companies and dividends themselves clearly rests in mutual companies. It is also present in those stock companies that treat blocks of participating business in much the same way with the same basic ideas. This is in contrast to other nominally participating policies which are issued by stock companies and which are not treated with the same philosophy. Dividends on such policies may be treated more in the nature of a non-guaranteed element in the policy that is set up at the time of issue of the policy and left relatively unchanged thereafter. It seemed to the Committee that such an approach did not necessarily have any criticism that could be brought to bear against it, except for the fact that it was not participating business.

It is the terminology perhaps that is the most annoying thing about this issue. It doesn't fit the mold so what we decided to do in the first step was to talk about the traditional approach in mutual companies or companies that treat participating business in what is regarded as a traditional fashion.

MR. GARBER: On the question of class we have a case where actuaries have had a traditional definition of what is a class for dividend purposes. The Committee has introduced something new called the experience factor which differs from that traditional definition. Tom, would you discuss the Committee's work in this regard.

MR. SUTTON: The concept that we are using really arose because of the fact that words are slippery. Because of that I went to a study note in order to write down the definition of dividend class. According to the most recent study note on this subject, a strict definition of "dividend class" is "a group of policies which are identical to a sufficient degree so that the respective policyholders would expect to incur identical costs." The study note then followed with a list of policy characteristics that might be used to form such a grouping -- underwriting classification, premium rate, plan and policy provisions, age at issue, sex, year of issue, and of course the list could be extended considerably.

There are two features of that definition which make it difficult to use as the cornerstone of an opinion on dividends. First there is the enormous number of dividend classes -- so many that any attempt to provide a one to one justification of cost between one group and another by an appropriate actuarial demonstration is just not possible. Further the fact that each dividend class contains so few policies means that its experience is scarcely credible. In practice this lack of credibility has led to broad cross-sectional groupings of policies with a given common characteristic. Sometimes in the literature and certainly in conversation, these cross-sectional groupings are also referred to as dividend classes.

The experience factor class is similar to one of these cross-sections in that the number of different experience factor classes can be brought down to a manageable low level.

The second feature of dividend classes is that they can be thought of as existing a priori. They are there whether or not somebody has identified them, and whether or not their respective emerging experience is yet divergent at a given time. A classical example might be the situation of life policies issued with disability benefits. In the early years of such a practice a particular company may never have consciously identified that characteristic as one distinguishing a dividend class. Also the current financial experience for policies with and without such a benefit may not have been different. It was only at a later time, when experience results diverged that different dividend classes were identified as such. Clearly, for the purpose at hand, an actuary cannot reasonably be called upon to justify any conceivable future dividend class. Further, it is not practical to call for justification of distinctions which might have been made but in fact have not been. It is true that equity may in a sense impel the recognition of certain factors which have significant financial effects. However, the operation of the competitive market in our economic system customarily provides sufficient motivation for making these differentiations. Hence the burden of responsibility should be directed toward justifying actual rather than potential distinctions. The experience factor class concept is entirely a posteriori, i.e. based on actual distinctions which have been made.

MR. WINTERS: I found the notion of experience factor class a helpful additional handle on getting after, as Tom says, the very slippery issue of what really is a dividend class. It may even intensify the concern that I have about internal consistency among the factors that are used for determining a particular dividend. In the current circumstances, whether we are on an IYM or portfolio interest rate basis, we are illustrating dividends on the basis of interest rates which reflect inflation -- portfolio rates to a lesser extent than IYM rates in the current situation, but both are, in part, inflation premium interest rates. When we iterate a dividend formula 20 times or so for an illustration without inflating the expenses at all, but use an interest rate which is inherently a part of an inflationary economy, a serious question as to the internal consistency of the results ten, fifteen or twenty years out arises. I think the experience factor class may even challenge us a bit more in trying to maintain consistency.

MR. HENRY B. RAMSEY: I think an example is the easiest way to get to my question. Let us say that a company has adopted the investment year method and it has a class of contracts that they began issuing in 1978. Let us also say that it has an 8% interest rate for the first year of its experience under those contracts and it is illustrating the tenth year under that basis. After reading the Report several times I believe that the last sentence of what is numbered Paragraph 3, which says the illustrated dividend should be based on the same experience factor values as are used for the corresponding experience factor classes of inforce business, might be interpreted to say that since this is that set of policies issued in 1978, the existing experience factor is 8% and should be applied to it. Is that the correct interpretation as the Committee would feel?

MR. JENSEN: I construe it this way. If you're illustrating a dividend for year 10 and it's 1978, illustrate a dividend for year 10 based on the 1968 IYM rate you are paying. Such dividends over 20 years would probably aggregate out to the same 20 year interest adjusted cost as under a portfolio approach, so that I don't suppose there is full attraction for this interpretation.

MR. GARBER: I think the Committee did not take a specific position on that, and specifically it didn't take Russ's position at this stage of the game. I think that as we get into defining how one would use the investment year method under this opinion, it will require a separate level of definition and that would be one of the questions that would be wrestled with. In my own mind I would read current experience to do just what you said but I would not think that if we believe interest rates are going to go up next year or in the next two or three years that one could start forecasting those increases and bringing them into account.

MR. SUTTON: My opinion is that the 8% rate would be continuously used and I feel fairly strongly about that in terms of the wording that's here. Whether that should be the case or should not be the case is a different matter, but I think the wording there is intended to mean that you would continue to use 8% in the future. I really want to make that particularly clear because the opinion in its first paragraph as to scope, says that it applies to apportionment and illustration of dividends for individual life insurance and annuities. We all know that there are a substantial number of companies that do use an investment year approach for annuities and declare, a new money rate which applies to policies sold in a particular year, and for illustration purposes assume a continuation of that same rate. The promulgation of this opinion, if it comes to that, is not intended to preclude those companies from following that current procedure.

MR. JOHN H. HARDING: I would like to congratulate Mr. Jensen for his valuable contribution to the serious consideration of the subject of dividend illustrations. My written discussion will include several points, but there is one that I would like you to consider today.

In cost disclosure regulation, there is a presumption that all companies illustrate their life insurance dividends on a comparable basis and that the competitive relationships established from those dividend illustrations will be indicative of current performance and of final result, when dividends are actually paid. Unfortunately, the 1974 Special Committee Report on Dividend Illustrations demonstrates that not all dividend illustrations fulfill these expectations. While many companies do illustrate dividends based on current experience, many use other bases which are not comparable.

If there are two companies with equal current performance and equal prospects for paying future dividends, their dividend illustrations should place them close together in competitive standing. But if one of those companies illustrates its dividends based on what it currently can afford to pay and the other one illustrates a projection of what it may be able to pay in the future, the competitive standings can be far apart. In this way the public is being misled.

The primary focus of our industry lies in the promise of future performance. As long as we permit the continued misuse of cost disclosure regulation -- that is, promoting its use while undermining its intent -- we call into question the very fabric of our business. The misuse is not limited to creating public confusion. Some companies who themselves illustrate on a basis of other than current experience, seem to become confused between their illustrations and the reality of their own current performance.

The 1978 report of the Committee on Dividend Philosophy is physically thin, but it indicates promising direction in dealing with professionally acceptable practices for both dividend allocation and dividend illustration. But, defining these practices and enforcing them will, as the report states, be a "lengthy evolutionary process." It obviously will take time to deal with many issues, including new money allocation and new money illustration.

But, with respect to dividend illustrations, we don't have that time. There is tremendous pressure to abandon current experience illustrations and to project dividends. Unless we can reduce that pressure, others will embrace corporate confusion. In addition, if we do not make sure that our cost disclosure methods provide fair comparison, there are all too many regulatory agencies that would be more than happy to try.

There is something that we can do now to move toward fair comparison. That something is voluntary disclosure of our bases of illustration. Mr. Jensen's paper includes the observation that for years we have emphasized what a dividend illustration is not, rather than what it is. We can disclose to the buyer now the basis of our dividend illustration. If it is based on current experience, we can say that publicly. If it is based upon new money allocation, we can disclose that. If it is based on projections of future experience, we can disclose that, as well as how these projections deviate from current experience.

The National Life Insurance Company takes seriously its obligation to its policyholders and to the public. The following statement is being considered for inclusion in our rate books in 1979:

THE MEANING OF NATIONAL LIFE'S DIVIDEND ILLUSTRATIONS FOR LIFE INSURANCE

Mutual life insurance companies <u>pay</u> those dividends which they can afford, based on their current operating expenses, claims and investment return. The National Life <u>illustrates</u> its dividends on the same basis, rather than upon projections of future experience. That is, National Life's illustrated dividend scale is based upon its current level of expenses, claims and investment return, adjusted to reflect differences in policy guarantees.

The dividends illustrated here are for illustrative purposes and are neither guarantees nor estimates for the future. Extensive testing has been done to demonstrate that if the levels of current experience were to remain unchanged throughout the period for which dividends are shown, the National Life would be able to pay all dividends illustrated. Dividends actually paid in the future will differ from those illustrated to the extent that future expenses, claims and investment results differ from current experience.

WALTER N. MILLER: John Harding and his company are certainly to be commended for their efforts to make a more meaningful statement about illustrative dividends. It's interesting to note, however, that the draft John read could be used without any change by a company which had adopted either an investment year method or a portfolio rate method of handling the interest factor in their illustrative scale. We should consider whether an improved dividend statement should be silent on the company's approach to this question.

Let me also take this opportunity to observe that the issues we are discussing here, and that the Matz Committee has been grappling with, are critically important ones which are at the cutting edge of the potential conflict between an actuary's professional responsibilities and his job responsibilities.

In this forum this morning and in others in the past, we've heard some strong views expressed on various aspects of the dividend philosophy question. By some remarkable coincidence, almost every one of the professional actuarial judgments I've heard on dividend philosophy has coincided with the position of the employer of the person offering the statement. This is not the only area where such an observation can be made and I'm not trying to say that there is something wrong with the phenomenon by definition. But I do believe that if we are unable, as professionals, to come to grips with these difficult problems and develop a satisfactory professional discipline ourselves, then we will be creating a vacuum. And this will be a very dangerous vacuum because it will be sure to be filled by other people or other organizations in ways that can only have a serious adverse effect on our professional identity and well-being.

So, let's determine to fill that vacuum ourselves and in this spirit, I hope that the Matz Committee will go forward, leading us, in continuing the excellent work they've already done.

MR. DALE R. GUSTAFSON: I simply want to commend John Harding and The National Life Insurance Company for giving us a fine example of leadership.

We have been examining the same idea very closely at the Northwestern Mutual. National Life's example will cause us to look at it even harder.

The history of this situation is very simple to state. Until about the early 1930's, the complete details of dividend scales frequently appeared in annual statements. It seems that the advent of data processing, first in the form of punch card equipment, enabled the actuary to become more sophisticated in his dividend formulas. It was at this stage that the formulas started to disappear from the annual statements. They had simply become so complicated that it was thought that they did not provide meaningful information.

There were no changes in regulations or statutes that brought about this change. As a substitute, the beginnings of the now Schedule M showed up.

This is the age of disclosure. Maybe it is time for us all to go public with the details of our dividend philosophy and practices.

Certainly, modern dividend formulas are too complex and sophisticated for everyone to understand. However, regulators and other actuaries would understand them.