

RECORD OF SOCIETY OF ACTUARIES 1979 VOL. 5 NO. 4

DIVIDEND PHILOSOPHY

Moderator: EDWIN B. LANCASTER. Panelists: HARRY D. GARBER,
THOMAS C. SUTTON, JOHN H. HARDING, D'ALTON S. RUDD

1. The Committee on Dividend Philosophy's "Recommendations Concerning Actuarial Principles and Practices in Connection with Dividend Determination and Illustration."

While the entire Report of the Committee is open for discussion, the following is a list of areas which may be of particular interest:

- a. What special problems should be anticipated in extending the recommendation to annuities and to other kinds of participating business of stock companies?
 - b. Should the recommendations deal more specifically with the desirability of recognizing material differences in experience?
 - c. What additional special provision, if any, should be made for investment generation methods?
2. The Roles of the American Academy of Actuaries' and the Canadian Institute of Actuaries' Committees on Dividend Principles and Practices.
 - a. The development of further interpretive material.
 - b. Actuarial certifications to management and for Annual Statement schedules.
 - c. Caveats for dividend illustrations.
 - d. The application of recommendations to special situations, e.g., certain business of stock companies.

MR. EDWIN B. LANCASTER*: We will start with a housekeeping item. In the final report of the Committee on Dividend Philosophy there were two typographical oversights in Section 3. The last sentence of Section 3.2 should read, "However, those factors may or may not appear in the formulation actually used to calculate the dividends." In Section 3.4, Recommendation 3, the last sentence should read, "The report should also describe the formulation used to calculate dividends."

*It was necessary for Mr. Lancaster to leave the session before its completion. Mr. Garber assumed the role of moderator in his absence.

I would like to emphasize that our main purpose for holding this meeting is to elicit as much reaction as possible to this report. This project is not yet complete and it is crucial that we get your reactions at this stage.

MR. HARRY D. GARBER: I will try to cover what the history of the work of the Committee has been or subtitle: "How We Have Gotten To Where We Are Today." The Committee was appointed in March of 1976, so it is now three and a half years old. This is the third open review session we have had of the work of the Committee. There were two kinds of concerns that led to the Committee's appointment. One was cost disclosure, with its increasing public emphasis and questions that existed as to uniformity and comparability of dividend illustrations and the adequacy of the disclosure generally. The other area of concern was the dividend distribution process. There were a number of questions - do they meet appropriate standards of equity? do they favor new vs. old? large vs. small? are they too influenced by competitive considerations? and overriding all of this was the effect of the introduction of the Investment Year Method (IYM).

The Committee came very early to one of its fundamental principles of action, a principle which guided its work ever since. I will read it because it was stated very well in the first report.

"The Committee believes that whatever constraints are placed on the dividend process should preferably require disclosure of practices, rather than prescribing a narrow range of allowable practices. Reasonable diversity in the making of the many judgments required has been and should be encouraged."

I might add that the Committee thought that the process of change that might result from its work would be an evolutionary one and it would have to start with disclosure in order to determine the direction of any further actions that were required. This is a fundamental principle and you will see it coming through all of the work that we have done.

The first year and a half we concentrated basically on the questions of cost disclosure and dividend illustrations. This was the area of greatest concern and we thought perhaps that the problems that were highlighted in the dividend illustration area were more susceptible to quick remedy than the consideration of the whole dividend allocation process. We looked at two separate questions: what should be the basis of dividend illustrations, and, given the decision there, how should the illustrations be related to the dividends currently being paid?

On the question of basis of distribution there are really three possibilities. One would be to base illustrations on historical results. Another would be to use projections of experience, a basis which would be of most interest to the prospective policyholder, but the problems of discipline here are really beyond our ability to cope with right now. So we were left

with basing the illustrations on current experience. This is what we are doing today and is the basis that has been the subject of so much controversy. But the Committee believes there is really no other choice. We must see if there are ways in which we can make it work better than it appears to be working now.

The next task, if we are going to separate out dividend illustrations from the allocation process, is to try to define a relationship between illustrations and paid dividends. With both paid dividends and illustrations being based on current experience, we thought that there might be a way to establish a connection between them and avoid the necessity of reviewing the basis of the dividend scale itself. For example, there should be a definable relationship between the 10th year dividend currently illustrated for an ordinary life policy of a certain size, say \$50,000, and the current year dividend for an otherwise similar policy issued 10 years ago. We made several attempts to find these kinds of relationships. We looked both at a process that would lead us mathematically from the dividend we are paying to an illustration, and we also looked at trying to define a process that would set a range of possible relationships. After several attempts we came to the conclusion that we could not find any basis which was appropriate and which conformed to our basic principles.

For example, our first principle was that the emphasis should be on disclosure and not prescription and certainly the approach tended to get into the prescription area. Secondly, the Committee believes there is a clear need to permit companies to respond effectively to changes in economic conditions and the competitive marketplace, recognizing that competition is not just among life insurance companies or even just with life insurance policies. Finally, the Committee believes that the dividend illustrated should relate to the pricing practices which the Company intends to follow on the policy being issued and not to pricing practices on policies issued many years ago. We could not find any method really which would satisfy these criteria and which would also establish this sort of relationship.

The conclusion then was inescapable that we could not deal with dividend illustrations alone. Illustrations really are a subcategory, a very important one, but still a subcategory of a broad dividend apportionment process. We concluded that the Committee must deal with the entire process. This ended our first year and a half of work and that was the essence of the report that was submitted two years ago. I will quote from the conclusion of that report: "The Committee believes that what has been demonstrated is that the dividend practices require the exercise of skilled professional judgment, the results of which are neither unique nor amenable to rigid prescription. Those judgments clearly lie in the domain of the actuary and it is the natural conclusion that actuarial organizations have a duty to recognize and strengthen the basis on which individual actuaries perform the tasks through the formulation of appropriate guides and opinions relating to conduct in this area."

In the last two years the Committee has been seeking to develop suggested guides and opinions. Last year we prepared an opinion, a Proposed Opinion S-7, which was presented in a report and discussed at the annual meeting in Chicago. The Board of Governors accepted that report and asked the Committee to continue on its course of developing the recommendations that would be the basis for that opinion. In so doing, the Committee was to recognize that some of the areas that we have been concerned about, the areas of disclosure and regulation, should rather be handled by the Academy of Actuaries Committee. What we have presented this year was essentially a report to summarize where we had been and also a set of detailed recommendations.

The Opinion and the Recommendations exclude the determination of the amount of dividends to be distributed. This is a matter of management judgment, to be made with the recommendation of the actuary. It is really outside the scope of the actuarial considerations. Therefore what we are dealing with in the Proposed Opinion and Recommendations is how a company distributes a lump sum of money, the amount of which has been decided. The Recommendations and Opinion endorse the contribution principle, but we have not sought in our recommendations to tie the distributions or the effect of the experience factors to the sources of earnings. For example, we have not tried to define a method by which the interest rate distributes what one might consider the interest earnings of the company. This was a very difficult area and we have chosen not to get into this yet at this time. What we have done is to focus on the question of the differences in the treatment of different policies and different policyholders. Whenever the experience factors that are used in the dividend formulas, or in the work that leads up to the dividend formulas, differ from one policy to another, the actuary must justify these differences.

The Opinion and Recommendations do not require that differentiations be made; the Committee is willing to rely on the marketplace to make these kinds of distinctions. If anything, the marketplace forces more distinction than perhaps is necessary. We have successively limited the comprehensiveness of the Recommendations so that we would have a basic core we could deal with quickly. We have cut out annuities, not because they should not be dealt with eventually, but because the time required to deal with this subject would have retarded the presentation of the Recommendations on life insurance. We have limited the Recommendations to the par business of mutual companies and stock company participating business that is conducted in essentially the same fashion for similar reasons. Finally, I want to reemphasize that the recommendations are guidelines, but the emphasis is not on requiring actuaries to follow those guidelines as much as it is on requiring disclosure when they do not follow them.

MR. JOHN H. HARDING: Over the past year the Academy Committee has had a close working relationship with the Society Committee. We have had as many as three overlapping members on the two Committees. In addition, the Chairmen of both the Academy and the Institute Committees have sat in on most of the meetings of the Society Committee. Of course, the focus of this concurrent session is primarily upon a report of the Society Committee and that is where the emphasis has to be at this time. What we are talking about is setting standards of practice which are far less permissive than the informal standards that presently exist. This is particularly true with regard to dividend illustration. The focus of this session is - can we, actuary to actuary, agree on what the standards of practice should be? The range of such practices is necessarily broad and many practices are close to the limits we believe must be disclosed. Once we actuaries do agree upon what that range should and should not include, the Academy Committee has the responsibility in the United States to implement those standards and to address the public. As the Society Committee mentions in its report, it still has work to do with regard to a final report and further interpretation. It also has to deal with the stock company policies specifically exempted at this time. In addition, deferred annuities will get further scrutiny. However, there will come a point when we expect that the Society Committee will say that it has completed its job and at that point any further interpretations will be handled by the Academy Committee.

The Society Committee recommendation anticipates a written report by the responsible actuary setting the framework which supports the dividend recommendation. The addressee of that report was deliberately left unspecified in order that the Academy and the Canadian Institute could make the best use of it. The Academy Committee basically agrees that the scope of the actuary's report may be far too broad and too technical to be delivered as such to a company's Board of Directors. It is probable that this report will be made at a lower level and remain on file in a company. However, the public will necessarily be apprised of any important exception and disclosure language required in that report.

The Academy has considered Schedule M and its utility in the disclosure and regulation process. There are only two areas of real agreement. First, it could be appropriate to include the actuarial certification of dividend determination and illustration in Schedule M. Second, the present variety of disclosed dividend determination methods in that schedule is of little use. Whether or not we use Schedule M, we are committed to public disclosure of the important exception and disclosure language required in the report.

At the consumer level the required disclosures will also need recognition. For example, if tests have been made which demonstrate that the current dividend scale is not necessarily continuable even if current experience continues unchanged, or if the actuary has reason to believe that current experience will deteriorate in such a way as to invalidate the dividend illustration in the immediate future, those disclosures must be included along with the dividend illustration.

By far the toughest job the Academy will have to face will be to make a fair, informative statement about the differences between illustrations based upon investment generation methods and those based on portfolio average. We must come to some acceptable method of dealing with this very basic issue of non-comparability. Failure to do so would force upon us a much less palatable solution.

With regard to that business of stock companies which is exempted from the recommendations of the Society Committee, the Academy Committee must move ahead and develop language which initially clearly states that such business which is exempted is not fairly comparable with business which is included.

Deferred annuities also deserve Academy attention, perhaps before the Society has completed its work in this regard. Deferred annuities are frequently being used today in replacement situations and very often the suggested advantage of such deferred annuities in combination with term insurance is the result of noncomparability.

Virtually all of what I have said about the Academy Committee today is in the future tense. It was impractical to forge ahead with the implementation process until we knew what it was that we should implement, but we have enough information to go on now. The current exposure draft is good enough and probably close enough to the final version that we can begin to use it as is. It is essential that the Academy Committee move quickly in order to give our cost disclosure system a reasonable chance to work. The goal of our Committee is to recommend the framework and to begin its implementation in 1980.

MR. D'ALTON S. RUDD*: Though I am the Canadian member of the Dividend Philosophy Committee of the Society of Actuaries, I am on this panel as a member of the Committee on Dividend Principles and Practices of the Canadian Institute of Actuaries.

While the charge to the corresponding Committee of the American Academy is concerned primarily with implementation of standards of practice, you will note that the charge given to our Committee of the Canadian Institute was somewhat broader including a study of the underlying Actuarial principles and related matters of philosophy as well as guidelines concerning appropriate standards of practice. This arises because the Canadian Institute of Actuaries does have a research and philosophy role in Canada. However, it is not the intention to duplicate the role of the Society of Actuaries and in our Society Committee, we are doing our best to ensure we have an "International" approach to the philosophic questions. After all, many of our Canadian companies do business in the United States, and there are several

*Although Mr. Rudd was unable to present his paper at the meeting, it is included for informational purposes.

large mutual companies domiciled on this side of the border doing extensive business in Canada. We all hope that jurisdictional differences will have minimal effect on the philosophy, though, of course, they will come into play in various areas of application. The most obvious difference is in the government statement presentation. Other factors arise from differences in approach by the National Association of Insurance Commissioners and the Provincial Superintendents of Insurance in Canada.

North of the border, in some ways our situation is much simpler. An example is that stock companies federally registered issuing participating business must maintain the necessary separations of accounts to determine the profits with respect to such business. Shareholders are limited by statute to a percentage of those profits ranging from 10% for a small participating fund down to $2\frac{1}{2}\%$ for a large participating fund of over \$1 billion. We do not have the wide range of quasi-participating business, if I may use the phrase, that is apparently current in the United States. On the other hand, our Federal Superintendent of Insurance has become concerned over non-participating single premium accumulation annuity forms of contracts where the interest rate is guaranteed for five years, or ten years, and then subject to change. There have been suggestions made from his staff that this type of business should be classified as par.

Our new financial reporting for federally registered companies has also brought the Valuation Actuary into the picture as he must certify that the reserves are adequate to carry his dividend scale - they must be explicitly or implicitly covered by the valuation. The federal and provincial government statements have long required us to report the principles of our dividend scale formula though in recent years we notice that many companies are reporting less and less hard information. In some cases, the description almost looks like a couple of paragraphs lifted from MacLean's textbook. Other companies still describe the dividend scale interest rate for determining excess interest and the method and formula for the amount of mortality profit, though in these computer days, loading profit descriptions are becoming pretty general. The Federal Superintendent used to publish this exhibit in his annual "Blue Book" but I regret he has omitted it in the last few years.

I might mention here that a committee of the Ontario Legislature is currently examining the life insurance industry and at least one member must be a follower of Mr. Belth. On several occasions he has mentioned his concern that policyowners should know how their dividends are determined.

Through the Canadian Life Insurance Association working with the Superintendents of Insurance, we have relative uniformity in Canada on questions such as illustrating the current scale and including an appropriate caveat. However, as our interest rates have risen further and faster than yours, some of us are becoming concerned about dividend illustrations and accumulations of dividends at interest rates based on current 8-9% portfolio returns

over decades into the future despite the caveat that may be on a ledger statement given with the policy. The Superintendents of Insurance have guidelines on illustrations of equity policies and new money annuities if the return is over 7.5%. Thus, projections of 10% portfolio returns may well become subject to these guidelines also. This would involve predicting downward rather than using the current scale, while, on the other hand, a new and growing company may feel a need to predict on something more favorable than current expense rates assuming a larger volume of future in-force. That material from the Society Committee contemplates the possibility of a prediction downward.

Our Committee has as yet only held an organizational meeting and drawn up a list of 13 topics to look at. We are thus looking at the Dividend Philosophy Committee of the Society of Actuaries to perform the fundamental philosophic work. Following the results of this meeting, we will no doubt be in a position to start dealing with its application in Canada.

MR. ARDJIAN C. GILL: I would like to raise questions on three sections. First, on Section 9, Expense Factors, I was surprised by the statement that acquisition expenses could be spread to all policies or recognized in the policies in question. The idea of spreading them to all policies is in conflict with the contribution principle as it is set out in Section 2.

In Section 10, Tax and Other Factors, Recommendation 14 is nice and general, but the preceding explanation implies that the allocation of Federal Income Tax follows the allocation of gross investment return rate to the block. It should be recognized that if the Menge formula is second degree, you just cannot add up the pieces that you get from individual block calculations and get the total income tax of the insurance company. Also, total income tax is affected by factors such as the deductibility of dividends and tax exempt securities.

In Section 12 there is some mention of testing illustrative scales to see if they can be paid. However, there is no element of compulsion to change those scales if the actuary discovers they cannot be paid. Does this section relate to new illustrative scales under consideration or to retesting of old scales that are already in effect? Does the Committee think that an actuary should just let illustrative scales persist even if they cannot be paid?

MR. THOMAS C. SUTTON: First, the testing referred to certainly does apply to in force and illustrative dividends. One of the things that received some discussion in the Committee was how close a tie there would be between actual experience and factors that were used to calculate dividends. It was concluded generally that the tie is tenuous at best. For example, a company that had a large amount of previously built up surplus conceivably could use an interest rate in a dividend scale that was somewhat higher than could be justified based on current experience in order to distribute those previously

accumulated gains. Now a company that chose to do that in a manner which is equitable with respect to all blocks of business, would not run afoul of the Committee's recommendations regarding the contribution principle or equity. However, the conflict arises in that sooner or later you will have distributed the excess surplus. Therefore, on an ongoing basis you could not continue that scale. That is really where Recommendation 12 came in. That is, if you have chosen to currently distribute dividends at a rate greater than that which you could continue more or less indefinitely, then you should point that out because of the potential future problem. There was no intention to limit the legitimate distribution of gains which have been previously accumulated which management has decided to no longer retain.

In regard to Section 10, you mentioned the rather parochial use of the Minge Rule and Phase II companies in the United States. The second paragraph, under 10.1, was intended as an example. In the last paragraph it says: "Therefore, tax factors which appropriately reflect these elements may be incorporated in the determination of dividends." We used the word "reflect" in this document in a number of places. The intention of the use of that word is not to say that there is a direct mathematical relationship, but rather that the elements that are commented on in fact bear in a reasonable way upon the result. We realize that there are many details, such as the small business deduction, non-taxable dividends, and many others including the item previously mentioned, so that the pieces do not necessarily add up to the total. The word "reflect" covers some of that without deviating from the underlying intention.

On acquisition expense, one of the reasons for not being more specific about it is that, aside from contractual agent commissions, there is a large amount of company expense that may be assigned as acquisition expense or assigned as renewal expense. The area of judgment seems so broad that, to set down a rule which one would be able to interpret almost any way, would seem to be pointless. Besides, there are arguments in the study notes and in other sources that say that the acquisition of new business is to the good of the company, and that the cost of acquiring such business should reasonably be spread over all business. So that really was not a point that was subject to a lot of controversy in the Committee.

MR. GARBBER: You have to recognize that if you are using a three factor formula and a set of expense rates which decrease over time you are, in fact, charging current acquisition expenses to old policyholders in the dividend formula. That is what is happening in the real world and it is one of the reasons we did not believe too much precision is warranted on the subject.

MR. SUTTON: It is also one of the reasons why you have to test the scale that you are illustrating prospectively. Unless you have provided adequate expense recognition in the block that you are now selling, it will not be able to adequately provide for those expenses at some future time.

MR. THOMAS F. EASON: I have some questions relating to the actuary's report, Paragraph 1.6, Recommendation 1. This recommendation reads in part as follows: "Whenever an actuary advises an insurance company on dividends, either illustrative dividends or current dividends, he or she should prepare a written report which documents the advice. Such a report should include a statement describing the framework of facts, assumptions and procedures upon which the advice was based." I assume that the report described will be generally available, certainly to the company's Board of Directors, and very probably to the Insurance Departments or other people who are interested in it. Will the Committee be dealing with what ought to be included in the report with respect to disclosure of transitional changes? Two such changes are: Type A - method changes from past practice in determining the dividends on existing business, for example, recognition of the extent of policy loan utilization in the future whereas it has not been recognized in the past; and Type B - when past methods have been oversimplified and do not comply with the recommendations of the Committee. Will a description of the procedures both before and after the change be required in the actuary's report when the prior procedures were perhaps less than professional?

MR. HARDING: The Academy Committee is addressing the issue of the report and how to make use of it. If you try to draft one of these reports you will find it is far too inclusive to be made useful for general public consumption. The disclosure and exception language in such a report however can be boiled down to a relatively useful section that can be used publicly.

The two types of changes mentioned are referred to in 10.3. Recommendation 15 in 10.4, states that an actuary's report should specifically include any special adjustments which are made to dividends and that the actuary should be prepared to provide demonstrations which support the existence and magnitude of such adjustments.

MR. SUTTON: In our report we decided not to include any language about highlighting changes to experience factors, assuming that the new set of experience factors will conform with what is described here. The only type of highlighting that we do, that relates to changes specifically from one scale to the other, is in Recommendation 5, Section 4.3, concerning policy factors. If you change your treatment of so-called policy factors since the last dividend report, those changes in treatment are supposed to be highlighted. Also, if there are changes to smooth the transition from one dividend scale to another, such changes or such adjustments are supposed to be highlighted, described and commented on.

MR. GARBER: It should be clear that the intent is to assure that changes in the dividend scale are described somewhere in the report. One early version of our Recommendations had called for highlighting scale changes. This may have lessened a bit in these Recommendations. That is one point we probably should look at again.

MR. SUTTON: The question of who gets the report is a complex one. The more detailed it is, the less likely it is that it would be appropriate for the Board of Directors and it would certainly not be suitable for distribution to the public. The Board certainly should, however, see a report that shows the exceptions. The Board should be able to rely on the guidelines of the Academy and be looking at the exceptions to those. It should not be concerned quite as much with all of the other demonstrations here.

MR. HARDING: The Academy Committee probably will not be making any kind of specific recommendation as to what the directors of a company should or should not be told. It is not our function to tell Management what it should tell its Board of Directors. On the other hand, if we say what the company will have to disclose publicly, from a practical viewpoint at least, that much will be disclosed to the Board of Directors prior to that time.

MR. SUTTON: Some of these points relate to implementation of these Recommendations. I would like to elicit some comments about some of the principles that are included. One that the Committee spent a lot of time on is the contribution principle. When particular statements about the contribution principle were set down and examined, some of the logical consequences of these statements were surprising.

Let me run through a little bit of the history recording our treatment of the contribution principle. We started out with a rather lengthy section, including some of the language as we currently have, but which also included other language that was intended to reinforce the general concept. For example: "Equity requires setting a reasonable, appropriate and practical balance between two extremes. Complete recognition of the individual results of each policy and complete averaging of all results among all policies. The first extreme destroys the pooling of risk concept inherent in insurance and the second submerges valid and significant differences among groups of policies. The balance point of equity is influenced by professional judgment, social context, legal requirements and practicality of application all of which are subject to continuing evolution. These factors preclude the possibility of precisely defining equity." We went on to say that there are two implications of equity. "First, any differentiations which are made should be fair, supportable, and justifiable. Second, items which have significantly different financial effects on different groups of policies should result in recognized differentiations." These statements are followed by this one: "The operation of the competitive market in our economic systems customarily provides sufficient motivation for making these differentiations. Hence, there is a greater burden of responsibility for avoiding unfair discriminations than for introducing differentiations." In a series of changes, we eliminated some of the general language, but we were still left with the same general thrust.

At a later point, a Committee member wrote this comment: "It would seem to me that when the actuary concludes in his or her professional judgment that there are material differences between classes, the burden of responsibility for avoiding unfair discrimination may swing toward the side of encouraging recognition of these material differences rather than avoiding differentiation because of tradition or common practice. Where I see an extremely strong burden of responsibility is a situation where there has been a prior separation because of material differences and this separation is proposed to be reversed or eliminated." A version of the section on Contribution Principle after that, said this: "Averaging or pooling of experience is considered to satisfy the contribution principle in the absence of clear and specific evidence of material differences and experience among groups of policies. When there is clear and specific evidence the contribution principle requires that such differences be recognized in the determination of dividends."

There was an attempt at a definition of a material difference in terms of percentage of the total dividends that would be changed if a given event were to be recognized. When the Committee saw that in writing, it started thinking about the implications such as: does that force IYM on a company? does it force recognition of non-smoker mortality on in-force business? does it force recognition of female mortality as compared to male on old blocks of business? It led to so many questions and the reactions were so extensive that another attempt was made at simplification. The revised wording said: "Averaging or pooling of experience is considered to satisfy the contribution principle. When differentiations are made, the principle requires that they be based on clear and specific evidence." That led finally to what we have now.

Now that may sound rather abstruse and some of these changes may not appear very different from one another, but there was a great deal of thought given to this particular section and to what is meant by the contribution principle.

MR. GARBER: The question of what the contribution principle means and how it should be applied was of central concern to the Committee. We went through seven drafts. We walked up to the question of materiality, including attempting to define precisely what constitutes materiality. In the end, we concluded that we should rely primarily on the marketplace to determine which differentiations should be made. Our Recommendations require that any such differentiations be fully supported, but we do not believe actuaries should be required by these Recommendations to make any differentiations.

MR. SUTTON: Part of the original thought was that an actuary should reasonably be expected to justify differentiations which have been made, but it seems unreasonable for him to prepare justifications for any conceivable differentiation which has not been made.

MR. DONALD D. CODY: I want to raise the question as to whether the solution to the materiality problem is a workable one, and whether competition in the marketplace is essentially where price is eventually determined. We are dealing here not only with market pricing, but also with equity. The marketplace has been the cause of some of our problems. For instance, if a company were to go to the IYM technique, either modified or full, and did not change its method of determining expense allocations, the results would be rather striking. If you take a look at the pricing of the product, you will find that the pricing in the market is not necessarily directly related to the known cost of doing business of each company. So I regret a bit the loss of the requirement of materiality. I recognize its problems but I wonder whether the market is going to offer the solution.

We have a great deal more to do with respect to the approved actuarial methods of allocating expenses. When I listened to the method by which acquisition expenses are determined and the techniques of throwing gains from select mortality, for instance, against acquisition costs before they are allocated, I wonder about the extent to which the marketplace is going to solve this problem. It is a difficulty that will continue to exist. It may be that some of the other language of the recommendations will be helpful in solving the problem.

A second point is that equity, in the end, requires that the surplus development or the accumulated profit charges on each class of policy and each classification within a class have some relationship to the aggregate surplus of the company. The contribution method and the formulas that most companies use do not explicitly show what the surplus accumulated is, or what the profit charges are. Using the reserve to reflect the fund on a particular class of policies in the later policy years is not correct. There is a sizable surplus that develops on any class of policies in the later years. The Committee should give some effort to developing this profit charge and surplus concept.

MR. GARBER: By not dealing with the question of how much should be distributed as dividends, we tended to eliminate this consideration from our recommendations. The question whether we should take that up later on is one that the Committee should look at in the future.

Your early comments cover an area we really struggled with. We tried to deal in a forthright way with the whole question of inflation. We tried to suggest a consistent set of practices, so that if a company used IYM, it should also make commensurate recognition of future inflation in the expense area. Nothing shows up in the report because this came too close to basing dividends on forecasted, rather than current, experience and the Committee does not believe this is an appropriate basis for illustration.

MR. SUTTON: One attempt at dealing with IYM and some of its implications was to recognize that IYM would not be a problem if there were not different interest rates for different generations. The main cause of those different interest rates is inflation. In one version we had a section on inflation and its impact and how it may be recognized and reflected in dividends. The main motivation for framing it in that way was to say that IYM really is not the basic issue. The basic issue is something else - inflation. The objective then was to ensure that the actuary recognizes all of the implications of inflation in illustrated and in-force dividend scales.

One of the implications is different interest rates for different blocks of business. Another implication certainly is the rate of expense and the rate of expense change. Inflation, by definition, is a rate of change. In pursuing that line of thought, we were logically led to deal with rates of change and how rates of change were to be reflected in dividend scales. If you carry that thought further, you get into difficulties. You could as well state that rates of mortality are changing, so how about dealing with rates of change of mortality and rates of change of expenses other than those that arise from inflation. It led to an even larger can of worms. That led us to back off from that approach and to specifically address under an investment section, IYM as opposed to portfolio. We did not try to talk in great detail about either inflation or rates of change in general.

There are some references in this document to projection. The intention really is not to deviate very much from the historical way that illustrated dividends have been prepared; that is, dividends being based on current scale without a deliberate forecast of future conditions. The only projections that we are talking about in this document are those that are made on a relatively short time frame, such as the period over which the dividend scale is expected to continue. This is especially important for companies that are relatively small and cannot reprint a rate book every year or cannot change a scale every year, but may do so only every few years. The key thing that we wanted to bring out under those circumstances was that if you are going to do this kind of very short range projection then, for the sake of equity, you should project consistently for all your blocks of business. You should not, for example, merely use this short range projection for illustrations and not use it for dividends that are being paid.

In any case, that line of thought about keying off inflation, then concluding that inflation is a rate of change, and then developing recommendations and principles for rates of change and their reflection in dividends, led us to deviate too far away from the basis principle that dividends to be illustrated should be based on current conditions rather than forecasts.

There is another area here that perhaps people would like to comment on. It related to Section 3, The Process of Dividend Determination. In the first five drafts we had an explicit description of each of the principal methods. We tried to describe them as they are generally applied but this led to a series of difficulties. Part of the difficulty arises because of the variety of applications and the combination of different methods that different companies use.

Some of those considerations led us to introduce criteria that would characterize a method. One of them would be whether the underlying elements were used explicitly or implicitly. For example, a select and ultimate mortality scale used directly in the dividends where that mortality scale, in fact, represented the company's experience would be an explicit item. To the extent that the company uses an ultimate mortality table only, that might be regarded as partially implicit. Some of the third term might be used in such a way as an aggregate balancing item and so it would be, by definition, implicit, whereas the dividend interest rate might be explicit or it might not.

In any case, that distinction was attempted, along with a distinction that related to the number of factors involved, whether three, two or one. During that process, there was a desire on the part of some Committee members to relegate an experience premium method, which is a two factor method, to a second class status. A reversionary bonus method, which is a one factor method, would have even a lower status.

Another thought process led to the conclusion that we were concentrating on the wrong thing. The particular methods of calculating dividends really were not the issue. The issue was the underlying assumptions, or the process, as opposed to the formulations. Eventually we were led back to trying to recognize similarities of methods, rather than trying to enumerate them and point out their differences. The differences were more illusory than it seemed. At this point, we believe the approach we have taken is most appropriate.

MR. GENE ECKSTUT: Our company is a stock company which has historically sold par policies almost entirely. We are about to start a non-par line in addition to our par line. My question is what problems should our actuaries be aware of in satisfying the recommendations of the Committee and in writing the actuary's report?

MR. RICHARD S. MILLER: As a member of the Society Committee, I would like to reply to that. At this juncture, the Committee has taken the position that anything that does not clearly fall essentially within the mutual company practice on a segregated line of business basis, has not been spoken to. If the vast bulk of your business is par, then it is either being operated on the basis we are generally describing, in which case the recommendations do apply, or it is outside that basis and whatever recommendations we may come up with in the future should apply.

The proposed activity within the Committee is to look at all aspects of non-guaranteed benefits. That will specifically include policies with indeterminate future premiums, currently called non-par policies, where the premiums will be redetermined from time to time according to prospective criteria. We are going to walk up to that question. Whether we walk away from it or not is something we will find out in the future.

MR. THOMAS J. KELLY: To preface my remarks, I do not speak for the New York Insurance Department or my colleagues in the Department, but as a fellow actuary with some regulatory experience. I would just like to emphasize what your Committee has said. It is necessary for other members of the Society, besides those on the Society and Academy Committees, to contribute to the further development of the dividend philosophy being proposed. If the actuarial profession does not accept the responsibility for dividend philosophy, other interests will.

Tying in with that is the matter of disclosure which the Academy Committee will be facing. Especially here, our fellow actuaries can contribute a lot in determining what type of disclosure and how much disclosure. There will be pressure for more and more disclosure as various consumer representatives get involved in this area. The actuary should decide what type of disclosure is needed for internal needs and what type is necessary for the dissemination of information to the public.

MR. BRUCE E. NICKERSON: I continue to be concerned with a basic theme of the report which is the emphasis on not making projections. I see the emphasis on the contribution method as inherently being retrospective and not involved with making projections. Actuaries are regularly involved in various forms of discounting. I suggest that the process of discounting is merely the opposite side of the process of projecting. We have had a number of debates between the actuarial profession and the accounting profession, on ways of presenting financial information. In that context, the actuaries have on various occasions taken the position that for the accountants not to apply discount rates is equivalent to applying a discount rate of zero percent. The same thing seems to apply with regard to dividends. I have always perceived the basic principle of participating insurance as being one of deliberately charging premiums that are intended to more than cover the expected cost of providing the benefits themselves and the expenses. The dividend process is then used to provide insurance at cost.

A particular illustration of my concern is the hypothetical situation where a company has two comparable blocks of existing business with regard to which the retrospective experience has been, in fact, comparable, but where, for valid reasons, the actuary is persuaded that the future experience on those blocks of business will differ. In that case, the actuary cannot soundly use a no projection, contribution, historical only, approach to determining dividends. He must retain more margin in his dividend scale for that block of business where he or she is genuinely persuaded that future experience is more likely to be adverse.

MR. SUTTON: The last concern you expressed, about possible adverse experience, was what led us to Recommendation 18 which recognizes the fact that current experience may differ from a company's forecast of the future. If the forecasts are sufficiently negative in relation to current experience, that deviation ought to be recognized. That recognition on only the down side may not seem appropriate to some, just because it is not the same in both directions. However, the nature of illustrated dividends is such that many actuaries are uncomfortable if they feel that they cannot deliberately illustrate lower dividends in time of adverse experience, or at least make a statement to that effect in their report.

Another part of your comments relates to what I was describing earlier about the results of our attempting to deal with inflation. That led to dealing with zero rates of change, and non-zero rates of change underlying illustrated dividends. There has been a large quantity of material, for example Russ Jensen's paper, which has described the problems of dealing with forecasts rather than current experience. There are two different ways of looking at the future. One way can be illustrated by the smoker/non-smoker distinction. Suppose a company has never had that distinction before, so that it does not have any past experience. Now suppose it wants to introduce that distinction. It does not require making a forecast, but rather making a guess as to underlying current conditions for which it has no information. That process is not a forecast in the sense of projecting future conditions. In our report, we distinctly turned away from forecasts and considering non-zero rates of change in the calculation of illustrated dividends.

MR. GARBER: There is no prohibition in these Recommendations to prevent you from making a differentiation in your current dividend scale, and then illustrating that in the future on those two blocks of business. If you are willing to recognize today that these two sets of business are going to differ, you can introduce that into the current scale even though you do not have actual experience at all of the durations covered by the illustrations.

MR. PETER F. CHAPMAN: Although I am aware of the difficulties of projections and of defining materiality, I have to admit to being a little disappointed that the Committee did not emphasize more positively one facet of disclosure of future anticipations. When dividend scales are presented in the marketplace, they are frequently compared with past scales with the implication that the policyowner can anticipate future dividend increases because over the last 30 years the actual dividends paid have been higher than the dividends illustrated.

The next several decades may present quite a different picture. The Committee would have performed a useful service had it urged actuaries to look in a general way at the future and, within the realm of materiality and without necessarily making formal forecasts or projections, at least convey, when warranted, the idea that the future outlook as to interest, inflation, mortality and expenses, while not necessarily endangering the present scale, should not lead one to expect that future dividend histories will parallel past events.

MR. CHARLES F. B. RICHARDSON: One of the most vulnerable areas from the standpoint of public relations is the participating business issued by stock companies. It probably is not generally realized that there is only a small handful of states that even have any regulation on the separation of earnings as between par and non-par business, and still less in the way of regulation of the distribution of those earnings. I suggest that that should receive the attention of the Committee in the future.

MR. PHILLIP A. SCHORR: It has already been mentioned that if the Society Committee does not decide how the principles set out in its report are to be used, then somebody else will. I am not sure that turning the responsibility for disclosure over to somebody else is the way the Society can best serve its public or itself. Disclosure will not adequately handle switching around contribution methods, which is likely to occur, and is not in the best interest of the policyholders. For the Society Committee to set out an academic set of principles, which are all true, and then let another organization decide how we are going to present it to the public does not seem appropriate.

MR. GARBER: In the actuarial world, the Society does not have a charter to deal with the public. That is the Academy's task and that is why we have turned over this area to the Academy. But that does not get to the substance of your remark. The range of dividend practices is expanding each year. Therefore, our first effort must be to limit future expansion by the establishment of appropriate guidelines. As a practical matter, these must "grandfather" many current practices. The way I like to describe it is that we have drawn a great big circle, perhaps bigger than the circle we would like to have, but, at least from now on, no practices will be outside the circle without disclosure. As time goes by, information about disclosed practices will permit us to decide if the circle should be tightened. For now the first thing is to stop the expansion and to find out where we really are before we begin to move any more vigorously. We do not view this as a document that will stand for all time. This is really the first draft, from the point of view of the Society, of this document. Twenty years from now it will not look much like this; it will be considerably different as it evolves with time. However, you have got to get something written down to start a process, and that is really how we view this.

MR. HARDING: The Academy Committee is entirely composed of people who are both Society and Academy members and following what was said earlier, if we actuaries, whether you are talking about the Society or the Academy, want to retain control of what should be done here, the combination of Society and Academy better move rather quickly in order to do so.