RECORD OF SOCIETY OF ACTUARIES
1980 VOL. 6 NO. 4

DIVIDEND PHILOSOPHY

Moderator: EDWIN B. LANCASTER. Panelists: JOHN H. HARDING, DAVID R. JOHNSTON, RICHARD S. MILLER, JOHN A. FIBIGER

The Society of Actuaries' Committee on Dividend Philosophy revised its draft, Recommendations Concerning Actuarial Principles and Practices in Connection with Dividend Determination and Illustrations for Individual Life Insurance, to reflect comments received since Draft 7 was published in the Committee's September 1979 Report. This draft was submitted to the corresponding American Academy and Canadian Institute Committee for further consideration by the actuarial profession. This Draft 11 was distributed by Julius Vogel on June 18, 1980, to all members of the Society of Actuaries, and Conference of Actuaries in Public Practice.

These draft recommendations with certain minor modifications were included as Exhibit A in the June 1980 Report of the Committee on Dividend Principles and Practices of the American Academy of Actuaries. This Academy Committee Report also included "Possible Schedule M Disclosure" as Exhibit B and examples of "Possible Changes in Some Sections of the Life Insurance Buyer's Guide" as Exhibit C, along with comment on each Exhibit, background discussion, and a "General Framework for Implementation." A comment deadline of August 31, 1980, was specified.

Thus far, the recommendations concerning dividend determination and illustration have, generally or specifically, excluded nonguaranteed benefits included in the business of stock companies. In order to assemble information about this important subject, the Society's Committee distributed a questionnaire to chief actuaries of every U.S. and Canadian stock life company which employs one or more Society members. An article in the June 1980 issue of The Actuary discussed the questionnaire and solicited the views of individual actuaries.

This concurrent session will facilitate open discussion of all these matters. Prepared comments by panelists will intentionally be brief to allow as much time as possible for discussion.

MR. EDWIN B. LANCASTER: The Society of Actuaries' Committee on Dividend Philosophy was established in 1976. It flowed from a recognition of a number of things, one of which was that the practice of paying and illustrating dividends in a mutual life insurance company was more varied than what some of us from some large mutual life insurance companies had thought. It also flowed from a recognition that cost disclosure material depends heavily on illustrative dividends. There were some other motivations for forming the committee, but those were the two most pressing ones.

For the first couple of years the committee went down a number of dead ends in an attempt to decide what would be the most fruitful course of action for the committee, the actuarial profession and the insurance industry. We spent close to a year and a half pursuing various alternatives and finally came down to the alternative which we recommended in 1978 and which we have been working on ever since. That alternative was that the actuarial profession would establish certain standards of practice and recommended principles with reference to dividend scales for individual insurance and that the actuary, whether an in-house actuary or a consulting actuary, would make an annual report to management, setting forth how he had complied with these principles and standards. It was recognized that this subject is closely related to the regulatory practices both in Canada and the United States, and that the Society of Actuaries being the body that deals with actuarial principles couldn't carry out the whole job. Our committee was directed by the Board of Governors to cooperate with the Academy Committee and the Canadian Institute Committee concerned with this matter. In fact John Harding, the Chairman of the American Academy Committee, and David Johnston, the current chairman of the Canadian Institute regularly attend the Society Committee's meeting, and we attempt to operate as if we were one committee.

The Committee chose as a practical matter to break the job into two pieces. Our first effort was to direct our activities towards the dividend principles and practices for participating business of mutual life insurance companies and for the participating business issued by stock life insurance companies that act and carry on their business as if they were a part of a mutual life insurance company. For that purpose we chose to define the participating business of stock life insurance companies as that business for which earnings are limited to not more than 10 percent of the earnings of the participating business or 50 cents a thousand. The 10 percent/50 cents turned out to be controversial. Some people felt that the Society of Actuaries and the American Academy were inherently blessing those figures; we had no such intention. We were trying to break the job into two pieces, but in order to avoid this problem of our apparently endorsing the 10 percent/50 cents factor, at our meeting on October 19, 1980, we chose to delete from our recommendations the business of stock life insurance companies and just direct ourselves to the business of mutual life insurance companies for now. Of course, stock life insurance companies who chose to operate within this framework can do so and indeed are welcome to do so.

The second part of our job, is to deal with the very wide range of dividend practices of stock life insurance companies particularly in the United States. That part of the job is not nearly as far along as the material that you have before you.

Our panelists here are John Harding, who is going to lead off and who is the Chairman of the American Academy Committee; David Johnston, who is the Chairman of the Canadian Institute Committee; Richard Miller, who is our stock company representative and who is going to be heading a major effort in this coming year dealing with the practices of stock companies; and John Fibiger, who will speak from a point of view of how he views the recommendations operating within the framework of a United States mutual life insurance company.

MR. JOHN H. HARDING: My purpose this morning is primarily to update you on what has occurred since the publication of the Report of the Committee on Dividend Principles and Practices of the American Academy last July. The Academy report has three exhibits. Exhibit A is very close to Draft 11 of the Society's Recommendations and the differences between Draft 11 and Exhibit A are italicized. The focus of the recommendations in both of those documents is on disclosure to company management. The focus of Exhibit B is on how to use the actuary's report in a qualitative way for regulatory disclosure. The focus of Exhibit C is on consumer disclosure.

We published the report primarily to receive comments on the recommendations in Exhibit A. The comment deadline was August 31. All comments received by September 15 were sorted by topic and reviewed for several things. First we looked at the number of comments on specific items. Next, which items or criticism did we feel had to be dealt with before the recommendations could be adopted, and also, what were the other items which should be dealt with but could be deferred until after the adoption of the recommendations. The Society Committee met on September 25th and we made a report to them on the comments. Both Committees also met on October 19th to consider changes in response to those comments. There is general, but not unanimous, agreement that the Academy should proceed toward adoption.

The highlights of the issues raised in the responses are: We received about 54 responses; 23 of those could be characterized as positive, essentially endorsing the idea of moving ahead and asking specific questions or making criticisms; 26 were neutral in that they had comments and/or criticisms but didn't specifically say go ahead; and 5 could be characterized as generally opposed asking why are we doing this.

Looking at the volume of comments, certainly the most controversial issue was the stock company issue, and, as Ed Lancaster has already indicated, our response to that was to remove from paragraph 1.2 not only any reference to the earnings limit but any reference to stock companies. The implications of that, of course, are that, while previously Exhibit A made it such that a stock company could opt in, except for those policies which were not subject to an earnings limitation, now any stock company can opt in if it chooses. We expect that the disadvantage for not opting in would be the public disclosure of that fact. Meanwhile the Society Committee will now turn to the stock company problems, and try to make recommendations as quickly as possible.
There were about five responses with respect to the contribution principle in paragraph 2.1. Those concerns dealt with a possible strait jacket in the way we had worded the section in Exhibit A and Draft 11. In essence, there might not have been enough freedom to slope a dividend scale or deal with dividend scale changes. We agreed to revert back to wording closer to what was in Draft 7. This is the relevant portion of the contribution principle in paragraph 2.1: "The basic principle of dividend determination is to distribute the aggregate divisible surplus among policies in the same proportion as the policies are considered to have contributed to divisible surplus."

There were also about five responses expressing concern about the burdens imposed on the small companies in providing the resources to produce the report. Both committees believed that the concept of the report is fundamental to the recommendations. There is no way you can really do

the job of disclosure without such a report, but the Academy Committee could prepare some sample reports or other explanatory material which could be helpful to the small company actuary. One Committee member has already drafted a report for a small company, and he believes that the original report would not be too costly and that subsequent updates would be reasonably easy.

There were five responses dealing with the lack of clarity with respect to direct recognition of policy loans. The recommendations are essentially neutral on that topic because there is so little current agreement on that issue. We believe the recommendations on that item should be deferred. You can infer from that what you might do if you did want to try direct recognition, but the draft is basically silent.

One other item we are changing is Recommendation 20, and it is essentially the same in concept. Jack Moorhead gave an excellent rewrite of it that we all thought was worth including as suggested. I'll read it to you. "The actuary's primary professional responsibility with regard to illustrated dividends is to ensure that the dividends appropriately reflect the current financial results of the company and are related to paid dividends in an equitable justifiable manner. This responsibility must be adequately discharged despite the actuary's recognition of the important role that illustrated dividends play in product cost comparisons and competition in the marketplace."

While I believe we should proceed with the adoption of the recommendations, there are outstanding issues which will need to be dealt with within a reasonably short period of time. I've mentioned two of them, the stock company issues and probably the direct recognition of policy loans. Additionally, there is a housekeeping type of item, the original draft referred to Opinion 7. There is no Opinion 7 at the present time and there may not be one for a while. As of now, the Academy is considering a broader opinion which would avoid the necessity of having individual published opinions for each set of recommendations approved by the Academy. Until that issue is resolved, we will probably request that the recommendations be adopted without specific reference to an opinion. If the recommendations are adopted, there will probably be some changes within a year or two.

What are the next steps for the Academy Committee? Certainly, one thing we owe the people who wrote thoughtful responses is to get back to them. Those items which we have not specifically addressed by now, we will get back to and address in one way or another. I mentioned also the explanatory material that we think we should develop soon so that it will be available in time to be useful. We have received a number of comments on Exhibits B and C, and, along with the changes made in the Exhibit A, we think that B and C should be modified.

Finally, there is the process of regulatory and consumer disclosure. Before that disclosure process can work, the NAIC will have to incorporate something like Exhibit B into the Annual Statement and something like Exhibit C into the buyer's guide and into dividend illustration caveats. This won't happen overnight and it will take continuing work to help develop those requirements that support disclosure, which is the essence of the recommendations. There are many parties interested in the process of consumer disclosure. One of these,in particular, is the Advisory Committee to the NAIC on

Manipulation. Within that committee there is a strong interest and pressure to deal with many issues covered by these recommendations. For the time being, they are awaiting our results, but if we don't act soon, the NAIC may act without us.

In conclusion, the Society of Actuaries Committee has put a great deal of effort into the development of these recommendations. While one can argue for points of further refinement, I'm convinced that we have developed a satisfactory framework and we should adopt it as quickly as possible. There will always be a need for refinement but that need will be best met if the refinements are made to an existing framework. If we delay while dealing with refinements, we may find ourselves in the same position as that old Vermont company that failed while debating whether its buggy whips should be made of leather or naugahyde. We should go forward with the refinement, but we must also proceed at the same time with the issues of public disclosure.

MR. DAVID R. JOHNSTON: I would like to describe what is happening currently in Canada.

To begin with, the C.I.A. Committee of which I am Chairman does not feel that the consumerist and regulatory pressures being exerted on the U.S. actuarial profession regarding dividend matters exist to nearly the same degree in Canada.

We do, however, observe many symptoms of potential problems:

- the Canadian Life Insurance Association has been struggling for some time in regard to proper disclaimers to be used on dividend illustrations;

- the recent report of the Ontario Select Committee contained several references to concerns about dividend matters;

- problems found in the U.S. usually find their may north over the border.

Further, the Declaration of Guiding Principles of the Institute clearly anticipate that guidance will be given to members on important professional matters such as the determination and illustration of dividends, so adoption of Recommendations such as those established by the Society would be most appropriate.

In this situation, our Committee plans to develop C.I.A. Recommendations in much the same way that the Academy has, but to adopt a somewhat more deliberate tempo. We feel we should study the implications of the use of the Society's Recommendations in Canada carefully, and profit from the experiences of the Academy in getting them adopted. We will be having a panel discussion of the subject at the C.I.A. meeting next month and we are tentatively aiming to put Recommendations before the Institute some time next year.

We have several matters to consider in Canada:

1) Can we use identical wording to the Recommendations adopted by the Academy?

2) Are there additional matters to be covered in Canada?

In regard to both of these questions, one of our members is a member of the Society Committee and one of his prime functions is to ensure that the Society Recommendations are North American, not just U.S. Recommendations. Thus, there should be no problem on this score. However, I am still concerned that, being a different group of people, we may feel we want to cover some point in a different way, or we may yet find some practices peculiar to Canada that we need to handle. In general, we intend to try to use identical wording but we think that, so long as any Recommendations we produce are not actually in conflict with the Academy's, we could have some different wording. If there were any conflict, it would create a severe problem for actuaries dealing with both countries and there are quite a few of these in Canada.

3) Can we cover annuities or stock companies differently in Canada?

In regard to stock companies, the situation is sufficiently different in Canada that we think we can apply the Recommendations to Stock Companies as well as Mutuals. In regard to annuities, it may be that the Society will produce Recommendations before we take action.

4) The Academy's approach is to make their Recommendations apply to U.S. business (and, of course, only to members of the Academy). Is it appropriate to apply C.I.A. Recommendations to Canadian business (and to C.I.A. members)?

This question is probably more important to us because of the higher proportion of Canadian actuaries who work with U.S. business. An argument could be built on the grounds of professionalism that, in both cases, the Recommendations should apply to all dividends covered by an actuary's report; differences in standards of dividend determination or illustration in different jurisdictions could be allowed for. However, we currently feel the application of Academy Recommendations to U.S. business and C.I.A. Recommendations to Canadian business should be adequate. This will ensure consistent treatment of dividends in each country, although it could give an individual operating in both countries a problem if there are any conflicts. There will still be a weakness in Canada since the dividends of some foreign companies are not set by an F.C.I.A. (nor a member of the A.A.A.).

5) How does the report of the Valuation Actuary fit with that of the "dividend actuary"?

In Canada, the Valuation Actuary must file a report with the Superintendent of Insurance, outlining his assumptions and methods of determining reserves. In doing this work, he is required to comment or increase his reserves if he feels the dividend scale is unsupportable. If we got to the point of also having a report to the Superintendent by the dividend actuary, then it would seem possible there could be a difference of opinion between the two actuaries, depending on what the scope of the dividend report was. This additional complication will have to be considered carefully by the Institute.

MR. RICHARD S. MILLER: I handled the construction and mailing of a questionnaire to all of the stock life insurance companies in North America employing a member of the Society of Actuaries. There were about 300 mailings with 121 replies and five replies indicating that the addressee was not a North American stock life insurance company.

Out of these mailings, a couple of fairly clear conclusions could be reached.

One of the questions had to do with whether or not the companies felt they could properly allocate both earnings and surplus for purpose of being able to report no exceptions to the recommendations for mutual companies. A fair number of companies which did not have the legal obligation to allocate earnings and surplus, that is which do not operate in Wisconsin, New York, or Canada, did have some perceived difficulties allocating their cumulative surplus or their expenses to determine, for themselves, appropriate par business earnings.

Another conclusion that I drew was that direct shareholder profits were not a motivation in a significant number of companies for the issue and maintenance of a par line. What the motivation was is undetermined, but several companies indicated that no profits were being brought across to the shareholders of the par line.

A dominant number, 60 of 67, of companies writing par business answered that they did not feel any philosophical difficulty complying with, at that time, Opinion 7. Out of the 60, only 19 felt they would have any practical difficulty. A prominent source of practical difficulty was the expense of compliance. Very few made any comment which would indicate a philosophical or a management level difficulty with the proposed standards.

There were a couple of questions which dealt with the apparent conflict between marketing a par line and a non-par line simultaneously. There was no significant perceived difficulty in this area. Only two companies indicated any delay or lack of dividend changes to maintain consistency with their non-par line and the same two companies indicated some discomfort over the treatment of existing policyholders as a result of any delays that might occur.

I floated a trial balloon on the "cumulative preferred dividend" status which is similar in concept to the stock market preferred stock. That was shot down rather uniformly. Nobody liked the idea but me.

The comments almost uniformly were to the effect that the uses of the label "par" for practices which were never intended to be par should be forbidden or that the root cause, the inadequacies in the valuation and nonforfeiture laws, should be attacked.

A dominant majority of the participants felt that a stock company's obligation to demonstrate the propriety of any dividend allocations was the same as or somewhat less than that of a mutual company. A significant minority of stock companies writing par business felt more obligation to make this demonstration. Our original expectation was that the apparent conflict of interest might generate more obligation. As an aside, there may have been some difficulty in the construction of the question because it implied that there was direct documentation of the

propriety of the dividend determination available to the public as a current practice, and as a result it may be that the answer was more a theoretical answer to a hypothetical question than a practical answer as to what was being done.

There was considerable unease with the concept of applying mutual company philosophies to any portion of the business of a stock life insurance company and, in particular, to the emerging non-guaranteed benefits which are not labeled as participating benefits. The non-guaranteed premium policies or excess interest were consistently referred to as prospective in nature with the distinction being made that dividends are retrospective in nature. There were several comments to the effect that standards to be developed for such business should be developed by stock company actuaries and not by mutual company actuaries, and, in this regard, our committee is in complete agreement. Currently there are two stock company actuaries on the committee. We feel very definitely that any further work on the stock company question should enlist the aid of those interested stock company actuaries who would like to serve.

MR. JOHN A. FIBIGER: Because of my involvement on the Committee and the feeling of the management at my company that some changes in practice were coming, we have been working through some steps with our Board of Directors which might be interesting for you to hear about. Our experience points up the fact that there is nothing in the draft guidelines to prohibit companies from adopting tougher internal standards if they want to. The guidelines have been drawn in very broad and general terms, and we would encourage a company to adopt for itself much more rigorous and explicit principles and practices if it wishes.

We have developed with our directors, in very general laymen's terms, a philosophy of surplus earnings and also a philosophy of distribution of surplus. The surplus philosophy comes first because unless you have some general idea as to the surplus levels you want to hold in a company, you then find it very difficult to get some kind of accurate distribution of divisible surplus. We have a philosophy as to the level of surplus for the company that we deem adequate. Provided that we have achieved that level, we then expect each block of issues, whether it's a year of issues or a policy series or some other group, to contribute an appropriate amount to surplus. That contribution may vary by issue age, by the type of policy form and so forth. To get the new surplus we start with the old surplus augmented by any investment earnings on that surplus. To this we add the contribution to the surplus explicitly put into the policy forms and the amortization of prior issue expenses, and subtract the surplus drain from new issues.

We have been wrestling with the question of whether divisible surplus is really just the sum of the dividends we declare and pay or whether it is some overall amount that we set and then distribute to policyholders. Our Directors understand that an overall general level of divisible surplus comes out of a general policy about adequate levels of surplus. Of course, the actual surplus we divide turns out to be the sum of the dividends so that we are dealing with both a large overall target and also a sum of individual dividends to policyholders and the two should be approximately equal or we go through another iteration to make sure that they are.

On the basis of the surplus goals that we've set, we have written a brief 4 or 5-page description in very general non-mathematical terms for our directors of how we intend to go about developing our dividend scales. Once we had this policy, we shared with our directors, for selected plan-year-age groups, the actual numerical values underlying the current scale, the latest experience values, and then based on those two, either the reason for a continuation of the scale or the reasons for a change in the scale. We found it was fascinating to the directors to see the words in these policies translated into numbers, and, as a matter of fact, it has helped to alleviate their concern about discharging their obligation to be sure they are running the company for the benefit of the policyowners.

We have at least a preliminary draft of the actuaries' reports. At least in one area, the actuary's report to me as a member of management, indicates that our practices do need to be worked on in 1981, and I expect that they will be.

One last point that has come up with our directors is what we have come to call the theory of implied contract as to the method of dividend distribution. It arises out of potential change - when you want to change a pattern of initial expense amortization, or when you have a non-smoker policy and consider reflecting this for older policyholders or when you might be contemplating varying your dividends by whether an individual has taken a policy loan or not. Since at the time the policy was issued, there was a certain practice of combining or separating policyholders is there an implied "contract" not to change that practice. For example, at one time we did not separate males and females; up to almost two years ago, we did not separate smokers and non-smokers. Taking the smoking issue for example, if you go back and ask older policyholders whether they are smokers or not and give a more favorable dividend to those who certify that they are non-smokers, haven't you changed the rules of the game for those people to whom you sold the policies and illustrated the dividends on the assumption that the mortality of smokers and non-smokers would be combined? In other words, you have a question as to whether you are playing fair with your old policyholders who may have bought the contract on the assumption that smokers and non-smokers were to be treated in a certain way, expenses were to be amortized a certain way, or investment earnings were to be credited a certain way. The question is a very interesting one even given the legal right of your Board of Directors to distribute surplus in any way it chooses. Are you really treating everyone equitably if you change the rules of the game after that particular policy series has gone into effect?

MR. LANCASTER: Within our own company we've spent the last 2 to 2 1/2 years dealing with a committee of our Board on the question of dividends and some of the experiences we had are reasonably parallel to those that John has referred to in New England. Remember that the report that we're talking about in this draft document is a report internal to the company from the actuary to the management of the company, and not the report that goes on to the Board. This committee has very carefully dealt with the actuary reporting to management, and not management going on to the Board. Obviously the second step is implied and it's up to management to decide how they want to deal with the Board.

MR. CLAUDE THAU: The Committees have done a lot of good work, but I urge you all to participate. I believe that these Recommendations will be used heavily by legislators, commissioners, attorneys, judges, consumerists, agents, etc. Wide participation can help to achieve careful wording which will minimize misinterpretation. Regardless of the Academy's stance as to its applicability to stock companies, stock companies should study these Recommendations because compliance may be forced upon them.

As John Harding mentioned, most of the comments that the Committee received have been tabled for later review. The Committee believes we can produce an Academy statement now, and then modify it later before the NAIC acts upon it.

There are advantages and disadvantages to this approach. For example, it wouldn't surprise me if it becomes harder to change later or if it were encoded in some states, based on the current version. Those of you who are uncomfortable with this approach should speak up now.

Regardless of whether you feel immediate changes are necessary, you should comment about future changes you think we should make. Going through the effort of writing an Actuary's Report may help you to spot potential problem areas, so I suggest that you attempt such a Report this year.

I'd like to cover some of the problems that I see in the current draft:

1) Stock companies - The changes Ed Lancaster mentioned are a major improvement, but I'm very sympathetic to the criticism that we've done nothing about flagrant stock company misuse of the label "participating." With the alternative non-par products available today, we should expand 1.2 by adding: "They will apply to stock life insurance company policies issued after 1/1/84." While deferring the problems of applying these principles to in force business, we could at least cut off our problem block. Anyone here who is opposed to this comment should speak up today.

2) The guidelines are not intended to prohibit any practice but rather to require disclosure to company management if the methods do not reflect "generally accepted principles." Unfortunately, even some of the Committee members have had trouble keeping this point straight, talking and writing about "prohibitions." I think the following sentence should be added to 1.1: "It is not intended to suggest that following other principles is improper, but rather that variant principles should be disclosed and explained so that interested parties can evaluate them."

3) 5.6 is a troublespot. It was rewritten partly so that an individual's dividend could reflect his or her policy loan without having to disclose that practice. According to the Recommendations, directly reflecting an individual's loan in his or her dividend is generally accepted practice. I disagree.

   The revised wording also states "The placement of a policy within one experience factor class or another should be based on uniformly applied criteria designed to group together policies with similar levels of experience." Unfortunately, as worded, it suggests that

policies issued as a result of group conversions, term conversions, or guaranteed insurability options should receive dividends based on their experience rather than based on the experience of normally-underwritten policies. To follow that principle would be to violate specific or implicit contract guarantees.

A further complication is that "the actual occurrence or non-occurrence of a claim on a particular policy should not be a criterion for class placement of that policy." The word "claim" is not defined, but, ironically, the direct recognition of loans violates this statement as a policy loan is a type of claim. That clearly is not the intention of the Committee. If it were, I'd be willing to go along with 5.6 if the problem of conversions were corrected.

Varying dividends according to an individual's loan may be an acceptable principle but I don't consider it a "generally accepted practice" and I feel strongly that it should be disclosed.

MR. THOMAS C. SUTTON: Certainly, whether or not the Committee should take a position on a particular issue, such as policy loans, in a very specific way is a point worth considering, but in that area Draft 7 had a very long and convoluted set of language which tried to set criteria for class placement. The motivation that resulted in the change was not just because of the policy loan question. The policy loan was used as an example, one of several, that would create a potential problem if that set of clauses was applied literally. Another one that was really even more forceful was the question of jurisdictional taxation that arose after issue of a policy. If the original language was followed extremely literally, it would require specific disclosure of a practice which indicated that the dividend scale varied because of the current residence or jurisdictional location of policy, rather than the jurisdiction in which it was originally issued. For example, if one state came up with a rather exorbitant premium tax and you wish to reflect that in the dividends for policies whose owners currently resided in that state, it would have required specific disclosure under Draft 7. The other basic reason for making the change was because of the many comments that we received that the language in that section was close to incomprehensible. So, although it's true that it's different, the committee did not have an underlying motivation solely to make it possible to recognize loan utilization on a policy-by-policy basis after issue.

MR. OWEN A. REED: I can't help but feeling that maybe at this stage, there should be some workshop discussions of the report to find out whether, in fact, actuaries do agree on exactly what words mean in certain recommendations. I guess I'm drawing on some experience with the financial recommendations in Canada. When companies started going over the words with a fine tooth comb and then getting together, they found that there were a lot of difference of opinions in what things meant and, therefore, what was required in terms of disclosure. When the committee that was dealing with these recommendations came up with some explanatory notes, things became clearer. In fact, some companies felt that they could abide by the recommendations based on what was said in the explanatory notes but they couldn't abide by what they thought the recommendation said per se, and my own company was among these companies. It isn't by any means clear the extent of disclosure expected of an actuary, and it would be useful to have some sample reports.

MR. ERNEST J. MOORHEAD: I'm Vice-Chairman of a committee whose name was mentioned - namely, the Advisory Committee to the NAIC on Manipulation. I will say just a word about the committee's operation.

The question of the relationship between illustrations and dividends paid has been foremost in this whole discussion of dividend practices and procedures from the outset, and the Committee on Manipulation, in its modern form, came into being only in March of 1980 and produced a report during the latter part of the summer that is in the hands of the NAIC. We represent a deliberate and concerted attempt to see whether something could be done with a thorny issue rather rapidly. What the verdict of the profession would be on the usefulness of our report, I'll not attempt to say, but what we have done is to start the ball rolling, and we have come up with some suggestions for the interested commissioners on how the regulators might best exercise their perceived responsibility for riding herd on this question. Originally, the major difficulty of the committee was to define what the word manipulation is intended to mean, but we've come up with a definition that is reasonably clear although it is not acceptable to all the members of the Committee.

The committee is in some respects a pioneer committee in that the NAIC has moved somewhat away from its original idea of having Industry Advisory Committees and has framed the membership of this committee with the idea that it would be an advisory committee that would be fairly strongly populated by those who have some knowledge of this subject but are not members of the industry. There were some respects in which the committee tended to divide along a particular line with the industry members on one side and the non-industry members on another side. In spite of that there was a general politeness and harmony within the committee. The NAIC has asked the committee to continue its work so that those in this audience who have their doubts about the suggestions that we made can, for the moment, relax because it doesn't seem as though the NAIC is going to do very much with our report until we have done more work on it. There is, indeed, an intimate relationship between the work of the group that is being discussed this morning and the work of our own committee. We have been interested throughout in trying to keep in touch with what is being done by the Committee on Dividend Philosophy, and I expect and hope they will continue to keep closely in touch with what we are trying to do.

MR. D. S. RUDD: Mr. Chairman, as a member of the Committee, I am concerned that the panel has not raised a very crucial point which is dividing our committee.

There are two crucial provisions of our guides to professional conduct which would apply to an actuarial report:

1) Another actuary should be able to appraise the conclusions of the report, and

2) the implications of the report should be clear to those receiving the report - the management and perhaps the Board of Directors of the company.

It has recently become clear that some members of the Committee do not wish such provisions to apply to an actuarial report on dividends, notwithstanding the guides to professional conduct. In particular, there

is concern among some members of the Committee about including information in the report of the actual experience of the ordinary life participating line of business upon which the actuary developed his experience factors and his dividend scale. The principle of disclosure, at least internally, upon which the recommendations are founded, is seriously compromised. The actuary is sole judge and jury, deemed to be above review. The policyholders are asked to accept that the actuary is accountable to no one, not even his peers, nor those representing the policyowners.

This is an issue which strikes to the heart of professionalism. I trust the Board of the Society of Actuaries will turn a deaf ear to any attempt to permit the actuary to prepare his report outside of the usual and necessary guides for an actuarial report of such significance.

MR. LANCASTER: Bill Rudd is referring to a matter which has been discussed by the committee for at least two or three meetings and has not at this point been fully resolved. There are a number of practical and legal considerations involved here. I, for one, don't believe that it was intended on the part of the Committee that the actuary making the report should be accountable to no one. This is a matter that we've discussed at length.

MR. JAMES SMITH: I have a question of Dave Johnston. It's probable that this question should be saved for the CIA meeting in a couple of weeks, but the principle may well apply in the United States at some stage. There has been quite a bit of discussion in various sessions at this meeting about the variable premium policy, or policies with limited guarantees. I agree with Dick Miller that here we're talking about policies where the changes are made prospectively rather than retrospectively, and from that point of view, the policy form should be treated as nonparticipating. However, this is being questioned to some extent in Canada today. The Department of Insurance is questioning those policies pointing out that if they are treated as nonparticipating, the policyholder has no protection from completely arbitrary action by the Insurance Company. The Department goes on to suggest that they may well require policies of this type to be classified as participating, and my question for Dave is if part or all of this form of policy is required to be treated as participating do you believe that the present recommendations are appropriate for that class of business, or do you see how they might be changed to make them appropriate?

MR. JOHNSTON: First of all, I have a problem wrestling with your question because I don't believe that these policies should be classified as par. As you say, the Department of Insurance in Canada has questioned this situation where there is some non-guarantee in either premiums, benefits, or face amounts. They've done this because they are worried that the policyholder may not be protected from the shareholder, but they have been quite positive in suggesting that they would like recommendations on other ways of handling this problem other than going the route of classifying the business as participating. The Canadian Life Insurance Association is actively trying to put recommendations in front of the Superintendent, and I think they will and I hope that they will be successful.

MR. MILLER: Very definitely I would be dismayed if a development of that nature occurred in Canada because it would have implications for the U.S. and lend credence to a probable attempt by the Internal Revenue Service to label the uncollected premium relative to the maximum premium as a dividend. That treatment within the federal income tax for stock life insurance companies is an even worse disaster than the current Menge results for mutual companies. With that in mind, I have all along felt that an independent force which would assure equitable treatment of the policyholder was highly desirable under the indeterminate premium policy. One policy provision that we had considered before we came out with our actual version of that product would have allowed what we call a "bail out". In essence, it would have allowed a permanent-to-permanent conversion of a defined net amount at any point in time when an adverse premium action was taken; thus, imposing a restriction upon the company that unless they wanted to see a mass of their policyholders taking advantage of the best policy the company was currently offering, they better not increase premium rates. A rigorous investigation of the implications of the current non-forfeiture laws and the comparison of those values with the natural reserve developed by the policies convinced us that we could not write into the contract a tight clause that we were sure we would be willing or happy to follow in the future.

My personal opinion is that in order to provide the operational framework which the company will need relative to the IRS, the Committee will have to make recommendations to the NAIC for legislation or regulation, not recommendations to the Society or Academy for guides to conduct. Those recommendations might take the form of an actuarial certification that policyholders are being treated as well as if they had been permitted, without new evidence of insurability, to buy the best product that is available from the company at that time. I think that's a reasonable, but oversimplified, statement of the standard that the company should be held to under the indeterminate policy. Again, I ask for volunteers to help us form this description.

MR. GORDON C. BORONOW: Does anyone know of any states that consider an indeterminate premium policy participating or place restrictions on the earnings from that type of policy similar to the restrictions that would apply to stock company issuing participating policies?

MR. MILLER: I'm not aware of any state placing any restrictions on earnings yet. There are at least two states that have indicated that they may require prior approval of any change in premium before it can be applied to policyholders in their state. The ACLI, of course, is trying to fight this.

MR. WALTER SHUR: I'd like to urge the adoption of these recommendations at the earliest possible time. We have reached the point with the recommendations that we are beginning to talk about refinements in the language. It is better that those refinements come under actual operating conditions. There is no final set of recommendations here. There is no perfect set of recommendations and there never will be. These recommendations are going to be changing over the years as the public regulatory climate changes. The risks involved in adopting them seem small compared to the risks involved in not. It was mentioned

before that they don't prohibit any practices at all. A company can pay standard dividends on term conversions or it can pay substandard dividends on term conversions. It might have to make a disclosure in one case, but if it is satisfied that it has a good sound proper practice, it is not prohibited. The same thing applies to varying dividends by the amount of policy loan outstanding.

It is important that the adoption of the recommendations not be unduly delayed because of the complexity of the subject. People outside may not understand why it takes four years to come up with a simple set of rules for paying dividends in a fair manner when the companies presumably have been doing that for 50 or 100 years. If anyone else comes up with any guidelines for dividends, they will be very far removed from the guidelines that we have here. I think it's imperative that we move ahead and adopt these just as soon as we can, and then work with them as we gain experience.

MR. RODNEY R. ROHDA: John Fibiger mentioned the matter of smoker/non-smoker differentiation on inforce business. I agree with his statements in that the rules of the game back when we issued those policies did not differentiate between smoker and non-smoker. I've already received a few copies of Probe within the last month that call on the industry to respond to this challenge. Those copies I received have pencilled comments in the margin from our field force saying that it sounds like a terrific idea and, golly, what are we going to do about it.

MR. SMITH: The previous speaker questioned whether it was appropriate to divide an existing dividend class. To me, any action which splits an existing dividend class to the benefit of some members of the class and the disadvantage of other members of the class is completely unconscionable, I don't think it should be allowed.

MR. LANCASTER: I'd just like to make one comment on this question of splitting class. When I joined Metropolitan in 1939, the "leading" dividend cases in the United States were pretty new; Rhine against New York Life, Rubin against Metropolitan, etc. The Rhine case went to the question of what I would broadly interpret as splitting a class. This whole question of the implied contract that John Fibiger referred to and the financial aspects associated with the background of the Rhine case present interesting problems to wrestle with.

MR. FIBIGER: Our Board discussion has not been so much along the lines of what's legal for us to do but rather more along the lines that even if we can do it, is it a thing that we should do.

MR. SHUR: On the question of splitting an existing dividend class, I think one of the previous speakers made a point that was a good point. He said it is really not right to change the signals in such a way that it is advantageous to one group and disadvantageous to another. There is a half-way position that may be possible. Take a hypothetical case where there was no difference between male and female mortality at the time when a group of policies was sold and then, as time developed, the female mortality began to improve. You might ask whether it is reasonable, then, to pay higher dividends to females. I would see no disadvantage. The basis of illustration for the males is the same as it was at the beginning. They are not being disadvantaged by the improvement of another segment of that group. Now, that is a fine line and you can

argue that the males should benefit because they were in the same group. This is very different from the smoker question where, if you take an existing class and begin to pay better dividends to non-smokers, you have to pay worse dividends to smokers. You're changing the whole basis on which it was originally done.

MR. MOORHEAD: This conversation has taken a turn that distresses me no end, and I'd like to make a couple of points that I think have not been made on this matter of splitting a class. In the first place, this is not, by any means, the first time this has come up. It came up in the 1950s when the practice of grading expenses and dividends or premiums by policy size was first developed. At that time there was a debate, which died down eventually, with some companies taking one stand and some companies taking another. While I agree with the gentleman who used the adjective "unconscionable," I think the adjective he used was a great deal too strong.

There are really two points for a company to consider in this matter. First is what was the understanding that the policyholders who bought the policy originally had at the time they bought it. If they had any such understanding as has been described, I think it would be at least improper to make a change. It seems to me very doubtful that it can be argued that they had some such an understanding that would be violated and, therefore, splitting a dividend class has a legitimacy that the previous speaker didn't recognize. The second point in a mutual company is what is in the best interest of the whole body of policyholders, and I believe that the company can make a decision one way or the other on those grounds, as well, and, particularly, I think they have to consider the replacement issue. In the 1950s, when grading by size came up, a number of the actuaries who made the decision that this should be made retroactive were thinking of the replacement issue, and I think it was entirely proper for them to do so.

MR. JAMES F. REISKYTL: I also happen to be a member of the Committee. I'd like to respond to the gentleman who said it was unconscionable to split a dividend class. I would like to have him consider such items as voluntary actions that we all face in a practical world and in particular the smoker/non-smoker question provided on term conversion and guaranteed insurability options. It's fairly common practice in our industry to change class because the old class no longer exists, and, if you hold firm to the view you hold I don't quite know what you do. I presume you do not have a smoker/non-smoker class in your company, but if you do, you are faced with a dilemma of continuing a class that you no longer sell to or creating a combination class for these options because one might argue they were told they were going to be able to convert or purchase in a class that no longer exists. Here is a case of voluntary action, new classes being created, and I suspect the bulk of the society and the majority of the companies who have done so, at least have saluted it by saying if you can qualify, you can be put into a new class.

Another area which would also have to be considered before you take such a strong position is revertible term. At the end of a period, presuming the insured can qualify or not, he is put into one class or another. Neither we nor the insured knows at issue which class he's going to be in, but three, or five years later, he will be in a class. This type of policy is fairly widespread in the industry today. There are many, many examples of experience-creating differentials that were not known at

issue, and so the question is, when is a class determined? I would cite policy loans here. When borrowing increased and interest rates increased, differentials between policies with different loan interest rates were proper. To my knowledge all the major mutual companies have introduced a change to reflect these differences.

The final comment I would make is that there are many, many policyowners actions that change classes, for example, use of the nonforfeiture options. You could argue they have changed classes. In fact, there are probably more cases where we change classes and change dividends than where we do not. There are so many things happening today, that we have to re-think our position as to whether we should never change the class.

MR. JAMES L. COMPERE: On this point of making available non-smoker discounts to prior series, there's a basic practical problem that bothers me about this whole process. Presumably, you don't have the information as to whether the person smokes or not. This means that you have to have the cooperation of those individuals to make that determination. Whether you do this on a mass mailing or some other basis, what's the guarantee that you're going to get a good participation and response. We have found on our update program that 20 percent of the people don't even read the mail. Now, is it fair to those 20 percent for them not to have the ability to get this non-smoker discount? There's going to be some non-smokers in that 20 percent. What about the individual who is in fact a smoker and gets the mailing? If I smoke, I may not want to incriminate myself by admitting that I'm a smoker. What do you do about that? There's some real practical concerns that I see in developing this. Can you run into the possibility of some lawsuits as an end result?

MR. THOMAS K. GROSS: Mr. Reiskytl do you feel there is obligation to notify a policy owner who has a loan if he is placed into a class that is different from the class of people who do not have policy loans in determining his dividend next year?

MR. REISKYTL: As for myself, I believe it would be proper to inform the individual.

MR. MILLER: Within the answers to the stock company questionnaire, there was one other element that crept in which I'll term the zero sum element. To a large extent within our discussion of a mutual company's philosophy, there was the assumption that if you treat one class of policyholders better than they might otherwise be entitled to, that you were necessarily taking it out of the pocket of some other class of policyholder, and within a mutual company this is probably a viable position. Within a stock company, there arose the contention several times that this was not a proper interpretation with respect to blocks of participating business, and that the shareholders had the obligation to step in before any implication was extended to another block of par policies. In other words, if a block of par policies should be generating a loss, or if continuation of dividends as illustrated would generate a loss, then it was the shareholder's obligation to pick that up first before it was ever transmitted to a second block of par policyholders. This means that there are some very fundamental differences in the contribution principle as it is applied to stock companies. That is one of the items that we will have to investigate. I think there is a kernel of truth here, particularly in actual application.

MR. DANIEL J. McCARTHY: I understand the distinction you were making about the difference between stock and mutual companies, and my comment is not addressed to that directly, but it is addressed more broadly to the zero sum concept. I don't think that it is totally applicable, even for mutuals. Depending on what you do, you may have different replacement experience or a variety of other things that are different so that, although for mutuals it's tempting to think there's a particular pot of money and that whatever you do to split it up necessarily gives less to A if it gave more to B, that's not necessarily true. The size of the pot can change.