RECORD OF SOCIETY OF ACTUARIES
1981 VOL. 7 NO. 4

DETECTING POSSIBLE MANIPULATION: THE PEER REVIEW APPROACH

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1. What is meant by the manipulation problem?

2. How serious is it?

3. How does the NAIC Advisory Committee propose to deal with the problem?

4. What responsibilities do actuaries have in connection with this problem?

MR. JULIUS VOGEL: The term manipulation means designing policies in such a way that they have attractive net cost indexes but are, nevertheless, a very poor buy for the consumer. An extreme example of a manipulated policy would be one that has cash surrender values available for only one day at exact duration 10 and exact duration 20, so that it has very attractive 10 and 20 year net costs, but is obviously a wretched policy for anybody to buy.

Now for some background on the manipulation issue. For some time, critics of the current NAIC Life Insurance Cost Disclosure method --- which uses interest adjusted cost indexes --- have complained that the method lends itself to manipulation by actuaries who can design scales of premiums, dividends, and cash values that will make policies look better in the cost indexes than they really deserve to look. In response to this, about three years ago the NAIC appointed an industry advisory committee on manipulation to consider the matter and make recommendations. Originally, the committee consisted solely of life insurance company actuaries who were actively engaged in designing and pricing policies for their companies. Paul, Walter, and I and some others were members of that original NAIC industry advisory committee on manipulation, and I was the chairman. Shortly after we began our work, however, the NAIC decided that NAIC advisory committees should no longer consist solely of industry representatives. Accordingly, our advisory committee was considerably enlarged and ultimately included three well-known academics, Joe Belth, Bill Scheel, and Harold Skipper; plus Jack Moorhead, who became vice chairman of the advisory committee, and Tom Kelly, the chief actuary of the New York Insurance Department, who became chairman of the advisory committee. This was a very diverse committee and some of the early meetings were very spirited or, you might even say, stormy. But we did ultimately come together pretty much. We made two substantive reports, one for the June 1980 NAIC meeting, and one for the June 1981 meeting, and these will be discussed by the panel. The advisory committee has not met for several months and considers itself discharged.

Now I would like to introduce Walter Miller, who will discuss the first two questions under this topic, namely, what is meant by the manipulation problem and how serious is it.

MR. WALTER N. MILLER: Thank you. I would like to start by referring to a comment Julius made in his introduction about the diverse composition of the advisory committee on manipulation and that a number of our earlier meetings were spirited indeed. I would like to take this opportunity to say for the record, and with a considerable degree of personal pleasure, that I had never engaged in an extended set of meetings centered around one topic with a group as diverse as this, coming from so many different disciplines, and representing so many different interests. It was a very interesting and educational experience. Very obviously, we did not come out of the two-plus years that this committee was in existence totally agreeing with one another. But I know it is true, as far as I am concerned, that I came out agreeing a lot more with the other committee members than I would have thought possible at the beginning. I hope that Jack, Julius, and Paul would agree that most, if not all, of the other committee members probably have feelings similar to this. It was an interesting experience, and there was some pain. But progress can be made by getting groups of people like this together and saying "OK people, stay at it and let us see what you can come up with."

What is the manipulation problem? If there ever was a question to which the proper answer may be "Well, it is in the eye of the beholder," this could be it. The discussion in yesterday's session on equity, which generally had to do with the question "Well, what is equity?," could not and did not produce any conclusive answer or agreement among either the panelists or the audience. And maybe that is the only thing you can say about the manipulation problem.

Instead of trying to define the problem, I am going to talk about some of the situations that have been perceived, at least by some people, as being part of the problem; and maybe by carrying forward a portion of our discussion in that way, we will be able to make some progress. It is even possible to say that a definition of the manipulation problem is linked to equity. I remember one of the early meetings of our committee when we were trying to develop a definition of manipulation that would serve as a basis for one of our reports. It was suggested that maybe equity and manipulation were inextricably linked. Perhaps we could define manipulation in terms of a process, an action, or a situation that results in a lack of equity in designing and pricing life insurance or annuities.

I would like to read to you one section of the first report of the committee which relates to the peer review approach to the manipulation problem. It says, "Most policy designing is done by professional actuaries who are subject to the discipline exerted by their own guides to professional conduct. The opening words of the guides of both the Society and the Academy of Actuaries are these: 'Professional conduct involves the actuary's relationship with those to whom he renders service, with his employer, and with the world at large. In all these relationships, the actuary's concern is with his

own behavior and with the behavior of his colleagues.' If the Society and the Academy will make a practice of thoroughly discussing the appropriateness of various emerging policy structures within their own forums, the number of cases of manipulation with which the regulators would have to deal is likely to be minimized."

I will now mention some situations that were discussed by the committee. Julius mentioned one of the very obvious examples of manipulation: a policy with a strange termination dividend scale for which it is difficult to find any justification except that it makes the policy look good under a particular cost index or cost comparison method. Another situation that the committee discussed and that gave rise to a lot of questions was a non-participating permanent policy with reserves and cash values reflecting a split interest rate basis, say, 4% for the first 20 years, and 2½% thereafter. Now that is a policy under which the slope of reserves in the first 20 years is considerably steeper than the slope of reserves after 20 years when the lower interest rate is in effect. It has been typical for cash values on policies with split interest reserves to follow a similar pattern. Part of the manipulation problem is what should be done with respect to policies like these where any attention paid to results for the first 20 years is not going to tell the policyholder that the rate of cash value growth will slow up significantly thereafter.

One of the reasons that some companies adopted patterns like this was to enable them to improve their pricing; a split interest rate basis can be more tax efficient in the U.S. than a basis involving a level interest rate.

But there is another one also. If you go back beyond the mid-60s, we all recall that the so-called traditional method of making cost comparisons was in general use. It is possible to say that there were many policies in those years that, at least in some respect, were designed to look good under the traditional net cost method. Such policies usually had high premiums and relatively high cash values, especially around the 20th year. If they were participating they had relatively high and steep dividend scales. The progress of termination dividends is also more significant under the traditional net cost method than under an interest adjusted or other measure of cost.

Each person's definition of manipulation and how one thinks about it is, to a degree, a function of the system of cost comparison and disclosure that happens to be in general use at the time. Suppose that in some alternate universe Linton yield figures were the only ones that could be used for cost comparison and disclosure purposes. I think we would agree that in such a universe there would not be very many actuaries designing and pricing policies who would be concerned with what the interest adjusted 20-year net cost index looked like. So the mandated cost disclosure method does make a difference.

The committee talked about a wide variety of policies that have sharp discontinuities at some point in the pattern of premiums or dividends or cash values, and we will hear more about that from Paul. A lot, if

not all, of the policies are perfectly legal. They do indeed meet the standards set forth by the minimum non-forfeiture laws; some of them perhaps because the law was not written in contemplation of that particular type of policy. Deposit term might be an example there, and that received a fair amount of discussion.

In the participating arena, our committee discussed a lot of the practices or possible practices that are also discussed, favorably or otherwise, in the report of the Society's committee on dividend philosophy. A few of the kinds of things that the committee discussed:

1. The frozen dividend scale. The situation where a policy was issued with an illustrated dividend scale that was paid out to the penny over a long period of time, during which there might have been significant changes in the experience factors affecting the company's cost of doing business.

2. Unusual policy designs. With competitive pressures especially, there is a proliferation of these. To what extent, if any, should the actuary be able to justify an unusual policy design on a basis other than it compares well with more traditional products using the current cost index measures?

3. The committee discussed some products which are packages, like a term and annuity package. To what extent, if any, should an actuary make sure that there is reasonable disclosure of the differences in tax treatment between a term annuity package and a traditional permanent policy when the package is to be sold in competition with permanent insurance? I am not trying to suggest there is a definitive answer, but I hope I am giving you a feel for some of the questions discussed within the committee.

4. Two similar policies with different price structures where the company pays higher commissions on the higher-priced policy. Usually the sales results will go in a predictable way.

5. A practice where there are two policies that look similar, and the dividends are a lot better on policy A which does not sell much, but is the one that the company highlights in its advertising. On the other hand, the dividend record is not so good for policy B, which is a big seller.

To briefly answer the second question on the program, which is, "How widespread is the manipulation problem," my feeling is that it is less than many critics of the industry believe, and more than many of us and many of our companies are comfortable with admitting.

MR. VOGEL: Thanks very much, Walt. Paul now is going to speak on the third topic, which is: "What did the NAIC Advisory Committee have to say about these kinds of things?"

MR. PAUL J. OVERBERG: My assignment is to report on what the NAIC Advisory Committee proposed as a solution to the problem which Walt Miller just described.

Our committee proposal is contained in a relatively short 3½ page, double-spaced report together with a proposed amendment to the 1976 NAIC Model Life Insurance Solicitation Regulation.

As far as I know, no state has acted on our recommendation. However, the Insurance Commissioner of Virginia has distributed a proposal on life insurance solicitation which incorporates some of the committee's recommendations.

Our recommendations, or at least some of them, may come as a surprise to actuaries who have not been following this subject. If adopted, they could affect the way you do business, the way you design and price your products, and the way you determine your dividends and other nonguaranteed elements of your products. Therefore, I suggest you read our report and the proposed amendment to the Life Insurance Solicitation Regulation.

In any event, you should be alert to any action that the various State Insurance Departments might do in this area. If adopted, some of your products might end up as an embarassment to you or to your company.

Here is a brief summary of our June, 1981 Report:

1. We expressed concern about cost indexes that might entice an unwary consumer into buying an inferior policy.

   Much of our work was devoted to reviewing various methods that can be used to detect and disclose discontinuities in year by year cost indexes.

2. We expressed concern about the integrity of illustrated dividends and other nonguaranteed elements of life insurance.

   This goes beyond just telling the customer what is guaranteed and what is not guaranteed. We adopted most of the recommendations made by The American Academy of Actuaries' committee on Dividends, Principles, and Practices. They too, submitted a report to the NAIC last June and I suggest you might also read their report.

3. We also expressed concern over other types of indirect manipulation and we listed three examples in our report.

   A. The first example is a company that sells simultaneously two similar policies, one of which is a better value to the customer, but pays lower compensation to the agent. We expressed our concern that the customer may not be aware of the better value policy in all instances.

B. The second example involves participating policies offered by some companies which have relatively low cost indexes, but which are rarely sold. The company may use such policies --- rather than other more popular policies --- to demonstrate their low cost on policies issued in the past and a favorable comparison of dividends paid on those illustrated at time of sale.

C. The third example involves the possible lack of adequate disclosure of the tax consequences to the customer or beneficiary of certain combinations of Life and Annuity products which may be presented to the consumer as an alternative to a traditional Whole Life type contract.

Julius Vogel and Walt Miller, in their opening remarks, referred to the diversity of background of the various members of our committee. Rarely did we have an unanimous opinion on anything---other than the adjournment of our meetings---and even that was sometimes controversial. Therefore, when I was using the word "we" for "our" in my earlier statements, you must remember that not all committee members would enthusiastically endorse all those statements.

Nevertheless, you should be aware of the fact that such statements are on record and in print in the NAIC Proceedings. As this subject comes up from time to time---and I am sure it will---these items will not be forgotten. They will be repeated.

The enhancement of the NAIC Model Life Insurance Solicitation Regulation goes into much more detail and requires companies to notify their customers and potential customers and the insurance regulators, if their policies do not meet certain specified standards. I will give you a few examples:

1. The regulation would require each company to identify those policies which contain unusual discontinuities in their yearly prices. On such policies, it would require the company to caution potential policyowners about possible unreliability of the cost indexes for comparing with the cost of policies sold by other companies.

   Here is what you would be required to tell them:

   > "The cost indexes of this policy may not accurately reflect year to year policy cost. The policy has an unusual pattern of premiums or benefits that makes the comparison of cost indexes with other policies possibly unreliable. You should discuss this with your agent or this company. A statement of year by year information is available."

2. Companies would also be required to caution the prospective policyowners when their actual or illustrated dividends are

determined in a manner involving substantial deviation from the "Contribution Principle."

Here is what you would be required to tell them:

> "The illustrated dividends for this policy have been determined in a manner inconsistent with generally accepted practices. Read the Buyer's Guide and contact this company for further information."

So you can see, we were envisioning changing the Buyer's Guide, too, but we did not give specific wording.

3. Companies would also be required to disclose to prospective policyowners the method of reflecting the company's investment yield in determination of dividends.

   Here is what you would have to tell them, if you use IGM:

   > "Illustrated dividends on this policy reflect current investment earnings on funds attributable to policies issued since 19XX, and are based on current dividend scales. Refer to your Buyer's Guide for further information."

4. Companies would also be required to disclose and identify to the insurance commissioners and to prospective policyowners, any newly issued policy which has a discontinuity index in excess of a specified limit. The discontinuity index measures the uniformity of the year to year flow of premiums, dividends, and increases in cash values.

   Everytime you changed premium rates, dividend scales, or cash values, you would have to check to see if your policies complied with the published limits.

It should be noted that the regulation would also apply to inforce policies, as well as newly issued policies. Here is some of the required information you would be required to give on inforce policies:

1. Companies would be required to give statistical data---including illustrated dividends for the next 30 years, on any inforce policy, if requested by the policyowner. You would be permitted to charge a reasonable fee.

2. Companies that compute their dividends with a method that "substantially" deviates from the Contribution Principle, would be required to notify their policyowners of this fact each year.

   Here's what you would be required to tell them:

"The dividends paid this year on this policy were determined in a manner inconsistent with generally accepted practices. Contact this company for further information."

3. Companies using the Investment Generation Method on the day the regulation takes effect would be required to notify each policyowner of this fact, and

4. Whenever a company changes from the IGM to the Portfolio method or vice versa, they would be required to notify their policyowners.

That gives you a flavor of what the Manipulation Committee has recommended to date.

In our June, 1981 Report, the committee asked to be discharged, but indicated a laundry list of items that might be studied by a new and smaller committee or task force.

As far as I know, the NAIC has neither discharged the committee nor appointed a new one. Our report was "accepted," but not "adopted" by the NAIC.

It is difficult to know what, if anything, will be done with our report.

Some of our committee members visited with various State Insurance Departments late in 1980 and early in 1981 to determine their reaction to our June, 1980 report. Most of them had not read our report and some were not even aware of it.

However, after discussing it with them, they saw some merit in some of the concepts, but said we should put it in a draft regulation format. That we did and we now await their action.

Now, here is Jack Moorhead to discuss the actuaries' responsibilities.

MR. ERNEST J. MOORHEAD: First, I fear that I must object to one of the Moderator's introductory remarks. I am unhappy about his reference to policies that show attractive cost indexes but, nevertheless, are very poor buys. I think our problem is not those policies that are a very poor buy; the only way that nowadays companies can sell policies that are very poor buys is lack of public information; in short, public ignorance or agents who are interested in getting the largest commission they can. The problem is policies that are a good buy masquerading as a better buy, and they are a much larger element in this because the number of policies that are very poor buys that are being sold today is relatively small. Would you show any sympathy at all, Mr. Moderator, to that point of view?

MR. VOGEL: I think that it's hard to distinguish between good buys and very good buys in life insurance. I am more interested in distinguishing between very poor buys and reasonably good buys.

MR. MOORHEAD: Thanks for agreeing with me. I will move over to Item 4 on the agenda and, in view of the fact that Mr. Miller largely covered what I had intended to cover, I will start with this question, directed to anybody who finds it interesting. What is the record of the actuarial profession in speaking up on sensitive, internally controversial issues. This peer review approach involves just that, a willingness to say something that somebody can hear about these matters. I personally consider the record is improving in that the existence of this particular committee is an example of improvement. But I will give you, out of the history of the profession, three examples that I think ought to trouble us on this question. It should be understood at the outset that the earliest reference in the Transactions to manipulation occurred in the year 1932, and the individual who made that remark was speaking very largely on his objection to policies that paid dividends too early --- participating policies which paid dividends that under his definition had not been earned at the time they were paid. He was speaking, perhaps, of the rights of the existing policyholders. He was, throughout his life, considered a controversial individual, but highly respected as he got into his older years. The three examples, though, that I picked up from history are not back in the 1930s; one is in the 1950s, one is in the 1960s, and one is in the 1970s.

1. In the 1950s, how much was said about terminal dividends that could be heard by anybody outside small circles in the actuarial profession prior to the landmark 1958 hearing of the New York Insurance Department? I will not attempt to answer that question, I simply put it before you as an example of a matter that was troublesome, and ask whether the profession had much to say about it.

2. In 1963, the Society had a concurrent session on the question of the traditional method. I would suggest that those who are interested take a look at the report of that session in the Transactions to see how much that was really solid was said about the well-known drawbacks of the traditional method and the need for something different.

3. In the 1970s, when the question was raised of what needed to be done about existing non-participating policies in order to make it justifiable to expect those policyholders to continue paying their premium, how much of that were actuaries willing to talk about?

So, I sum up this particular part of the discussion of peer review by suggesting that we are moving in the right direction --- the willingness to talk about these matters --- but that we need to be aware there is always a tendency to slip behind in this whole matter. I will say to my colleagues on the panel this morning that I think we might all remember that this peer review matter was one of the matters that Walter talked about as being controversial. My memory does not quite enable me to recall what it was that was controversial about it. But maybe the subsequent discussion will bring it up. The choice is

between more regulation and less self-policing, or less regulation and more self-policing.

Since I wrote this, I have seen a remark made by Daniel Patrick Moynihan which was reported in The New York Times on September 14, 1981 in which he said "Industries that police themselves are rarely policed by the Government." The accuracy of Mr. Moynihan's statement is subject to some debate. But the point that he was making does exist.

I close this introductory remark by mentioning the three different ways in which peer review approach may turn up directly or indirectly to the extent that it is implemented.

1. Through the actuarial organizations as institutions, not necessarily by putting something into the Guides to Professional Conduct. They are, as the President announced this morning, being shortened and simplified, largely through our own moderator's efforts, and that is good. I'm thinking not so much of the guides, but question whether officially the Society or the Academy or any other such institution will have something to say when unhealthy practices seem to be proliferating or even just in the development stage.

2. Through the relationships in possibly an advisory capacity that individual actuaries may have with the state regulators. The question that comes up is when loyalty to the industry, to the profession, to friendly companies, may conflict with the matter of bringing up these questions on practices that just do not look right in the context that we are speaking of today.

3. Probably the most important way of all is not corporate through the Society or in a complaint vein to the regulators, but in our own discussions with other actuaries, perhaps mostly in actuarial clubs, which are becoming the ideal forum for discussion of practical matters, professional matters, and ethical matters. I believe that the more people we can find who will raise questions in such gatherings as that, the more likely we are to make Mr. Moynihan's statement reasonably applicable to our own profession. We tend to do the right thing, but so often we do not do it soon enough, and this may be a good example for the future.

MR. MILLER: In my introductory remarks, I did not intend to leave the impression that the peer review section of our first report, from which I quoted, was controversial within the committee. It is fair to say, however, that there was not a great deal of confidence within the committee that the peer review approach was very promising. I think the reason for that feeling within the committee was, looking back at the kinds of things that Jack has outlined for us, very largely non-actions by professional actuaries in a number of situations where there was a chance to take some action. Looking forward, I certainly subscribe to the proposition that to the extent that our professional actuarial bodies continue to leave vacuums like this, other people will fill them, and often in ways that we would rather not see them filled.

MR. MARK GANZER: I take issue with Mr. Vogel's remarks about the "obviously" manipulated policy providing cash values only on two days, the 10th and the 20th anniversaries. What is so "wrong" if someone established an insurance company whose marketing existence would last for just one day, provided a mechanism was in place to perform traditional insurance functions and follow up with policyholders on the 10th anniversary and/or the 20th policy anniversary?

A wise old actuary once explained to me that there is no such thing as an intrinsically "good" or "bad" insurance policy. His observations were reaffirmed by Paul Barnhart's article on "Cancer Insurance: The Insurance Industry's Whipping Boy." I now believe (and probably should have known all along) that the only things "wrong" with an insurance product are improper sales or disclosure practices, or inappropriate price/benefit relationships; the ultimate test of the validity of a product lies in its acceptance or rejection in the marketplace.

Historically, the insurance industry's "problems" regarding disclosure and "manipulative product design" can be traced to its unwillingness to provide adequate value measures to the consumer. The current "controversy" over whether the Linton yield or interest adjusted cost indexes is more appropriate is moot. The correlation of the relative rankings produced by these two indexes is sufficiently significant to make legislation of the use of one index or the other as more "appropriate" an exercise in futility. The important issue is to determine a system of cost comparison that maximizes utility to the consumer and minimizes expenses to the company.

The observation that there are no females in this audience leads me to conclude that either:

a. there are no females pricing life insurance products, or

b. there are no females pricing "manipulative" products, or

c. females do not perceive manipulation as being an issue which affects them, or

d. (no chauvinism intended here) the Universal Life session is sexier, or,

e. none of the above.

My own experience has been that my female colleagues are tougher "sells" than males. I suspect this is due to traditional sociological perceptions of males as providers rather than anything physiologically different. Mr. Moorhead's concern with good-buy policies masquerading as better-buy policies is my concern also. Mr. Overberg's concern that cost indexes might entice unwary consumers is quite valid and may be understated, based on my own experience. Although it is professionally embarrassing, I have purchased what I now consider to have been a good-buy policy masquerading as a better-buy policy. My purchase was materially influenced by cost indexes. At one time I

contemplated legal action against the selling company. I have subsequently rejected this notion because my own company is in business and I do not wish to give our competitors information which may improve their competitive position.

The proposed revisions to the NAIC model disclosure regulation requiring printed material to accompany the policy at issue and on renewal have several shortcomings.

First of all, we as an industry cannot sit back and pat ourselves on the back merely because we are providing printed literature to the policyholder. People are bombarded with printed material and too much information is confusing. For example, would it not be possible under the new regulations to provide the customer with more pieces of paper than are required? I suggest that the chances of a consumer reading all the "relevant" information that accompanies the policy are slim. Furthermore, the volume of disclosure literature called for is expensive to the companies and will ultimately increase the costs of the basic product.

It may be preferable to better train our agents about the products they are selling and, as Mr. Overberg points out, to warn of possible abuses among competitors.

In closing, I agree with Mr. Moorhead's observation that "we tend to do the right things---so often we do not do them soon enough," but would like to add this: "so often we do not do them for the right reason."

MR. ROBERT J. CALLAHAN:
The recommendations appear to be centered on traditional life insurance products. I suggest that more emphasis be directed to Universal Life products which present different possibilities for manipulation. Universal Life is a very recent product and many of the problems associated therewith may not have become evident at the time the NAIC Advisory Committee finalized its report.