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FUTURE DIVIDEND PHILOSOPHY

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MR. ROBERT M. ASTLEY: I am going to ask Bill Rudd to start off the session speaking on the implications of the American Academy and the Canadian Institute guidelines for dividends and the question of equity for dividend classes.

MR. D.S. (BILL) RUDD: As Ulysses said, "I am part of all that I have met" - or at least that's what the poet claims he said. While my work on the Society and the Canadian Institute Committees on Dividend Philosophy has certainly broadened my prospective, particularly with respect to U.S. practices and problems, some knowledge of my background is due my audience as it cannot but help colour my views. First, as Chief Actuary at one time and later Chief Operating Officer of a large Canadian stock company, I have both prepared and received dividend scale reports and presented them to boards of directors. Canadian stock companies operate under very strict rules requiring separation of accounts between participating lines of business and shareholder lines of business. The shareholders in large stock companies are limited to 2.5% of the participating profits to the extent they are declared as distributable to policyowners and shareholders. At least one-third of the directors must be elected by and represent the participating policyholders. The company I was associated with had a long history of emphasis on participating insurance. It was family controlled for most of the last 100 years and had a very high sense of responsibility towards the participating policyowners.

At the same time I have been part of the provincial commission regulating group pension plans for solvency, vesting and other matters for over 18 years. This has involved drafting laws and regulations, reviewing actuarial reports on pension plans and working with the Canadian Institute of Actuaries to improve the quality of those reports.

Finally, in Canada we have little of the "stock company par" problem of the United States. The American taxation laws make it impossible for American stock companies to operate in Canada on a branch basis to any significant degree. Participating policy dividends are fully tax deductible in Canada, but not in the U.S. Almost all use a Canadian federally registered subsidiary. There is thus very little unregulated stock company participating business north of the border.

Over the last 15 years unusual pressures developed on actuaries preparing dividend scales from taxation, inflationary increases in expenses, rapidly rising new money interest rates which reached extraordinary heights well in excess of portfolio average returns, and increased competition due to new disclosure requirements and cost indices. A survey done among chief actuaries about 10 years ago showed increasing differences in approach to cope with these pressures. Dividend scale manipulation to make cost indices look better became a concern of the NAIC. Controversial investment generation concepts came into play. Therefore the Society committee and parallel U.S. Academy and Canadian Institute committees were formed.

The actuary is the technical and judgemental arm of the policyowners' directors in their trustee relationship to the participarting policyowners to ensure that a fair and equitable distribution is made of real participating earnings over a policyowner's lifetime in the company. The dividend scale represents his attempt to meet this responsibility with respect to currently distributable surplus.

Disclosure to management and the board of directors is meant to be the key to ensure that this inter-relationship functions as it should. The Recommendations of the Society committee have been predicated on that basis and have tried to leave the actuary sufficient scope to carry out his long term tasks with reasonable flexibility. The Recommendation's concept of disclosure to management of what he is doing and to what degree, if any, he is deviating from the Recommendations, is at present the only discipline.

The American Academy is also concerned with disclosure to regulatory authorities, due to the considerable interest that the U.S. authorities have been developing in this question. The Canadian Institute has not yet needed to concern itself with this matter as both the federal Superintendent of Insurance and the provincial superintendents have left the question to the actuary and the directors. Details of the dividend scale, which used to be published in the Canadian government statement, have over recent years become more general in many companies' statements. In the latest version of the statement it is assumed that this informtion will be included with the Valuation Actuary's report to the Superintendent on his actuarial reserves. At present this is not a public document.

The Achilles heel of the system is a reluctance to provide full disclosure even to management. A majority of the Society committee would not include in the recommendations a specific reminder to describe the actual experience from which the experience factors were derived. This even extended to not expanding the quotes from the Guides to Professional Conduct which would remind the actuary that actual experience would be expected to be in an actuarial report. However, the Society committee has recently voted to do so in the next version.

The crucial item these days is the interest income and the degree to which it is subsidizing expenses, particularly across generations if not also within generations. Many actuaries were concerned that the recommendations did not outlaw the investment year method (IYM) of applying interest to annual premium participating policies. It is an acceptable method in the recommendations with a caveat that the acquisition expenses should be amortized on a correspondingly different interest basis. However, I wonder how many of the critics of IYM are holding back 1% to 3% of portfolio average interest returns in order to subsidize directly or indirectly acquisition expenses and thereby reducing the dividends at the longer durations on older policies for the benefit of the open issue block. Such a practice generally helps 10 and 20 year interest adjusted net cost indices.

However, whether or not quoted in the Recommendations, the sentences in the Guides to Professional Conduct omitted in the American Academy's version but included in the Canadian Institute's version, remain binding on the actuary. In particular the Academy's version of the paragraph discussing a member acting for an insurance company does not include the last sentence of the paragraph "Thus in such circumstances, the member should satisfy himself that the persons who requested the report are fully cognizant of the significance of his findings."

Similarily not included in the Academy's version of the Recommendations is the paragraph concerning Guide 4(a). It states, "Thus, Guide 4(a) provides for the inclusion in an actuarial report of such underlying data as are essential to the findings and the conclusions reported. The key test is whether another actuary unfamiliar with the situation would find the information sufficient to appraise the conclusions."

The Recommendations are designed to improve both the credibility of dividend illustrations and of termination dividends. The experience factors of the dividend scale for the open block should differ from those used for closed blocks of business only if the differences are based upon sound data, reasonable expectations, and equitable methods. There still remains the problem of the portfolio average versus investment year interest method. The Academy Recommendations on disclosure require that the approach be identified.

Termination dividends can be used to maintain equity despite statutory surplus strains, cash flow and other problems. Regulatory bodies have been justifiably concerned over their sudden emergence to considerably improve 20 year interest adjusted net cost indices. British companies have made extensive use of maturity bonuses. It was interested to read recently that one of the major British life companies made a point in an advertisement with respect to their annual report that they are now going to put more emphasis in improving the annual bonus. Incidentally, one of the problems we have in Canada is that the British companies operating in our country using the compound reversionary bonus system of surplus distribution do not consider that they operate on the North American contribution principle. Perhaps they are going to come closer with this extension of their maturity and termination bonuses into the annual bonus scale of active policies.

The messiahs of the new hot money non-participating products are predicting that traditional participating insurance has finally come to the end of its life cycle. If this is correct, termination dividends may become more common and precise as par funds wind down and the actuary is forced to recognize the emerging portion of the deferred acquisition expenses not allowed for in the reserve.

On the question of stock company update, the Society committee has been divided on the questions of separation of accounts and restriction of shareholder take. The Canadian statement automatically provides for line of business reporting and separation of accounts within both participating and non-participating into internal participation and non-participating funds. Revisions are bringing the separation of accounts concept into the Recommendations for even American mutual companies while the U.S. government statement reporting still lumps together participating and non-participating. The revisions are also saying that ordinary participating surplus should be differentiated from surplus in group and other participating lines. In the Society committee some of us feel that stock company par cannot meet the recommendations unless there are both separation of accounts and a restriction on the shareholders' allotment of divisible surplus.

This is particularly appropriate with respect to dividend illustrations. First of all surplus that is not being distributed or which has not yet been included in income and will later emerge for distribution, belongs to participating policyowners. Secondly if there is not restriction on the shareholder take, no matter what the actuary is currently presuming and using in his current dividend distribution to policyowners, its amount may be changed at the next board meeting or next change of control, leaving dividend illustrations very questionable.

Unregulated stock company par seems to be a very different animal from regulated stock company par in Canada, New York and some other states or company charters, and as it now stands appears to be very difficult to bring into the Recommendations and maintain the concepts of equity amongst generations and credibility amongst dividend illustrations. The actuary in an unregulated stock company is hardly in a position to tell the directors how they are going to run their business now and in the future when he has neither the backing of law nor the trustee concept of the mutual company and most regulated stock companies. Neither the Society or the Academy are in a position to dictate to shareholders in such companies and the member in the company cannot be placed in an untenable position. In fact the Canadian Institute Recommendations exclude unregulated stock company par and require the actuary to state that the Recommendations do not apply.

The heading of the Equity Among Dividend Classes portion of this programme uses the term "dividend classes". In the Recommendations we deliberately stayed away from that term using others such as policy factor class and experience factor classes. Some difficulties here were unresolved by the committee. A major problem evolving for companies and their actuaries is the finer splitting of underwriting classifications. Male and female differentiation in premiums or dividends is the earliest example. Smoking habit and life-style differentiations are spreading from term insurance to permanent insurance. The Recommendations are not particularly helpful on some of these points as the committees found it extremely difficult to deal with the question.

Disintermediation is mentioned in the program but does not appear in the Recommendations. In American statutory reporting, the sale of long term securities bought in more stable times will cause surplus reductions. In Canada, the loss is amortized through future investment income, but there are immediate income tax credits.

My own view is that one of the main reasons for surplus, is for protection against possible adverse investment experience (which is really independent of whether one sells for the tax effects). Thus the question belongs with surplus management, not with dividend scale determination. However it will affect dividend scale determination if divisible surplus is significantly reduced. Then in order to maintain long-term equity, the actuary is forced to reduce his annual distributions and to increase his terminal dividends. This is one area where the Canadian Recommendations differ in their emphasis from the American. The Canadians recognize that the contribution principle applies to each year's divisible surplus but in practice can be related to divisible surplus over an extended period of time. In such an event the procedures which lead to the longer term operation of the contribution principle should be described in the actuary's report.

On the effect of new products, we are moving in exactly the opposite direction in our two countries. In the U.S., taxation has become one of the main attractions for the Universal Life products in addition to the hot money returns being offered.

In Canada, it appears that the resolution of the November 1981 budget, which originally was going to place flow-through taxation of investment income to new policyowners, may work in the opposite direction. Whole life type policies will probably be exempt from such a provision, but not if they are going to turn into an endowment policy or a term rider on an annuity through large interest credits. Ironically this could mean that Universal Life in Canada could end up as a participating form of contract with excess interest in the form of dividends, not as an addition to the cash value. It still could be handled on a non-par basis as an experience credit, in advance or otherwise, ending up in something similar to accumulating dividends or paid up additions. The principle of the 1981 budget is that nobody is going to be able to accumulate interest income without paying tax on it at least every 3 years, Thus the exemption being considered for whole life insurance is being very carefully hedged.

On the final topic of Legal Implications I have only one general comment. If the actuarial profession, through its recommendations and the operation and disclosure of those recommendations, cannot assure regulators and consumers that the goals will be met, we will probably have more laws, and more public disclosure, resulting in policyowner directors and their actuaries being placed in a much more exposed position.

To recap, for me there are four main implications of the Recommendations I would thus hope take place:

i) Fairer treatment amongst generations of policyowners and amongst policyowners of the same generation.

ii) Dividends paid reflecting actual experience more closely.

iii) Dividend illustrations for new business on the same basis as for existing policyowners.

iv) Disclosure to management and directors of what is being done in the dividend scale in layment's language.

I believe unregulated stock company par business, without the limitations on the shareholder take, and appropriate allocations and separation of accounts to ensure the limitations work, is more analogous to unguaranteed non-par than the participating business issued by mutual life companies. Much of the unregulated par was issued with no thought of being of the same nature and cannot fit into the purposes underlying the Recommendations.

MR. ASTLEY: One supplementary comment to what Bill said, for those of you who are not familiar with the Canadian scene: The CIA version of the Dividend Principles and Practices standards, which the American Academy now has in place, will be voted on at the annual meeting of the CIA on June 10th or 11th, to be effective for dividend scales in 1984 if approved by the membership.

Next I will call on Dick Stenson from the Equitable Society. Dick is the only one of the panel who has actually had to comply with the American Academy standards so I know that his remarks will be of great interest to you.

MR. RICHARD M. STENSON:

I. ACADEMY STANDARDS

Before I comment on practical problems with regard to the Academy standards on dividends, I would first like to review these briefly. I realize these are familiar concepts, but I would like to look at them with reference to what I view to be the two primary themes underlying them. The major theme is the obvious one of disclosure - disclosure to the actuarial profession itself, to insurance company management, to regulators and to the public. A strong secondary theme is one of "exception reporting"; that is, reporting of changes in practice or deviations from accepted practice.

First, I would like to discuss "disclosure" to the actuarial profession. The guidelines and recommendations are intended:

- To set a framework for the actuary to practice within
- To spell out basic principles and practices for dividends in mutual companies
- To link illustrated dividends and paid dividends
- To establish a continuity of practice on general principles of equity
- To set a base for the actuary to deal in a professional manner with his work and with his management

In short, the guidelines exemplify what is expected of an actuary by his peers.

I should add that this first disclosure - to the profession - is really all there is, so far. Adoption of these recommendations by the Academy Board directly affects only Academy members. The other sets of disclosure I will discuss are in the nature of recommendations.

Disclosure to management is the next set.

A written report is called for.

The Actuary's client is the "company, policy-making executives and in some instances its' board and auditors".

To a great extent, reporting is by exception. Of 20 specific Recommendations, 11 focus (at least in part) on reporting change or deviation from an accepted practice. Any of the following must be covered in the report:

Recommendation

#1 Deviations from Recommendations

#2 Deviation from the Contribution principle

#4 Approximations should be supported

#5 Changes in practice respecting policy factors

#6 Projections should be supported

#7 Differences between classes of a particular experience factor should be identified and supported

#8 Changes in values of experience factors and placement of class

#9 Differences from specified claims factor classes should be explained

#11 Changes in or to portfolio or investment generation approach

#15 Any special adjustments should be supported

#16 Changes in practice with regard to termination dividend

Also, specific statements in the report are called for by 6 of the 20 Recommendations.

#2 That the Contribution principle was followed

#3 The process should be described

#6 Experience factor values should be described

#13 That the total expense charged to each class is justifiable and in accordance with sound principles.

#18 If the scale cannot be maintained because of expected deterioration in experience; so state

#19 Identify time period of portfolio or IYM rate of return

The remainder of the Recommendations are statements of basic principle:

#10 It is generally accepted practice to reflect policy loans in investment income

#12 Expense principles re charging and amortizing costs

#14 Variations in tax factors should reflect variations inherent in applicable law and regulation imposing the tax

#17 Test continuation of illustrated dividends if current experience continues

#20 Statement of general responsibility regarding illustrations, equity and marketplace role of dividends

I think this is a pretty extensive list of disclosures the actuary is expected to make to management. In my judgement, it indicates that no hesitancy whatsoever exists on the part of actuaries to communicate fully with their respective companies' management.

Disclosure to regulators is a proposed qualitative extract of the Actuary's Report, plus interrogatories in Schedule M.

The qualitative extract of the report to management would focus on a broad description of the general method of determining dividends and the justification for making distinctions in experience factors.

The Interrogatories would focus on:

- <u>Changes</u>
  - since the last scale was introduced
  - in illustrations, as well as in dividends for payment
  - relative percentage change in dividends by major block
- <u>Specific disclosure of</u>
  - any projections or forecasts beyond two years
  - IYM vs portfolio investment treatment
  - policy loan treatment
  - termination dividend payment and basis
- <u>Exception reporting</u> would be required if the illustrations could not be paid if current experience continue; or if there is a substantial probability the dividend scale could not be paid in the next two years because of deterioration in experience.

. Opinion that AAA principles have been followed.

The proposed Consumer Disclosure recommendations call for revision of the Buyers Guide. Commentary would be added on the nature of dividends; with specific reference to the possible effects of IYM vs portfolio treatment.

The other recommendations on consumer disclosure calls for revision of disclosure regulations for sales proposals, to require that they:

. State if the scale is not covered by the Academy principles

. Include specific language as to the nature of dividend illustrations, and disclose what the IYM block illustrations are based on

. Disclose, based on Schedule M interrogatories

  . If the Contribution principle was not followed

  . If the underlying experience was projected more than two years

  . If dividends are varied according to policy loan utilization on individual policies

  . If termination dividends are not paid on all terminations, or if they are not determined in conformance with acceptable practice

  . If dividends could not be continued should current experience continue

  . If dividends are expected to be cut because of deteriorating experience in the next two years

With this background, I would now like to discuss problems in compliance with the Academy standards, in the practical sense. The major one is one I have alluded to already. It is an actuarial profession issue as of now. After all, the first sets of disclosure within the profession and required of the profession in reporting to management are fairly new and are all there is, now. An evolution of the process is needed inside companies.

Other practical problems with management relate to their gaining of an understanding of the process and the equity issues; while avoiding an implication that each dividend represents an exact accounting of surplus to each policy. In this latter regard, we should note the change made in the Academy principles, after the exposure process, to define the Contribution principle as distributing dividends "in the same proportion as the policies are considered to have contributed to divisible surplus".

Basically the exercise is a good one. It is helpful to the actuary in requiring him to go beyond the purely technical description of the scale, and to an exposition suited for analysis by senior management who are not actuaries.

At my company, for many years we have asked our Board of Directors in October or November to authorize the dividend scale provisionally for the following year, so that notices for January cases can go out with an appropriate advance timing before the dividend due date (in February, when the Board receives our annual statement for the year just closed out, they act finally on the scale). This provisional recommendation has included a description of the changes in any experience factors, in the basis of any policy or experience factors and in the amounts of dividends set aside. In short, it has encompassed much of the context of the required Actuary's report; and its existence has made preparation of that report relatively easier to accomplish.

The major practical problem with regulators is awaiting the process of the development of requirements. If the Academy proposal is accepted by them, it should strongly reinforce the Actuaries' Report and the Academy guidelines.

An obvious practical problem in the public disclosure aspect of the regulatory process lies in the preservation by individual companies of proper internal control of proprietary pricing data. It is my belief that this enhances the strong competitive environment in the life insurance industry in the U.S.

At the consumer level, the major practical problem is the proper conveyance of some fairly sophisticated differences in dividend philosophy, without overwhelming the customer with a level of detail or complexity that becomes incomprehensible, and without putting a label - good or bad - on alternative acceptable techniques, while still giving the customer the information he needs to know in order to make an intelligent buying decision. This is not easy to do. Concepts which seem simple to actuaries are not necessarily easy to describe to others. An example is the interest adjusted surrender cost index - for which I have not yet been able to find a really good description which satisfies even fairly sophisticated non-actuaries.

One such practical problem related to consumer understanding, that the Academy Committee spent a lot of time on, deals with comparability of sales illustrations, as among investment generation methods and among universal life type contracts and annuities illustrating a current rate. This issue cuts across lines of business - and it troubles some because of the inability of establishing a quantitative measure of the difference between these techniques and traditional portfolio dividend approaches.

The Academy committee concluded, at least on the investment generation question, that no prescription exists for a simple solution to the question of quantitative comparability, calling instead on disclosure of the time period of investment returns underlying illustrations, with an understanding companies would then use this information to develop their own explanation of the competitive effects of these techniques.

In short, the Academy report focuses on disclosing the non-guaranteed nature of dividends, and requiring certain specific disclosures. Variation of policy loan by utilization activity on an individual policy basis would be another example of such a required disclosure.

II. Investment Income Allocations

. Asset Allocation

My company established a segmentation of our general account beginning in 1981, under which assets backing the individual Life and Health Account became a separate segment. These assets are still part of one general account, though, in the aggregate. This approach is expected to produce, besides a better management rapport between investment officers and the officers responsible for managing prices and dividend scales for the life line, a gradual change in the structure of the portfolio better suited to the line itself, its liability structure and the demand for policy loans. We now have a written, separate internal investment policy for this segment, and have moved toward greater liquidity and somewhat shorter maturities (although the latter is a slow process) in recognition of the continuing potential for disintermediation.

As yet, there are no real implications of this change on dividend policy, because the bulk of our assets flow from the line's historical share of the various pre-1981 investments. Carl Ohman, of my company, is participating in a teaching session on this subject following the meeting's close, here in Colorado Springs.

In future, the possibility could be considered of separate segments within a line, if distinctively different enough products - as, say Universal Life - were issued by the same company along with its regular products.

. Equity Investments

Equity investments have always been difficult to adapt to the dividend process. My company has had relatively little in its life line for a number of years.

The major problem is one of a generally moderate return in terms of the stock dividend with regard to the purchase price; the balance being expected to be made up for by capital appreciation.

One approach I have heard of is to use a rate of interest on contemporaneous non-equity investments for pricing and dividend purposes, with the understanding that results for the equities in the aggregate may be expected to match these rates long term. This approach, though, may be better suited to non-participating coverages than to dividends. Another is simply to use the actual return on the equities in the work underlying the dividend scale, taking account of capital appreciation and gains as they occur through the simple mechanism of setting divisible surplus. If the latter is used, capital gains should be examined by investment year block if an investment generation approach is used, to assure relative equity per block.

. Investment Year Method

My company has used an investment year approach to dividends for a number of years. We vary the dividend investment income factors by policy issue year blocks, relying on the stabilizing effect of combining several years of issue to dampen the volatility otherwise possibly implicit in the method. Our current illustrations, for instance, are for issues of 1976 and later. The paper by Don Cody sets up the possibility of using a weighted factor to balance dividend investment income factors somewhere between the investment generation and portfolio methods. In the non-traditional product area, it seems clear that the burgeoning Universal Life type products are simply illustrating a current investment year result.

. Subsidiaries

Our major life subsidiary sells life insurance and annuities on a non-par basis only; and its earnings (or losses) are channelled back to the individual life line of business. As an investment of the whole line, its earnings naturally affect the total amount of divisible surplus which could be set aside, and thus impacts dividends to customers in an across-the-board manner.

MR. ASTLEY: Thank you Dick. Our third speaker in the rotation is Claude Thau from the Transamerica Occidental. Clause is the actuary primarily responsible in his company for recommendations on par insurance. Any of you who have been at various sessions of the Society in the past years will know that he has some very articulate and well-thought out views on the issues of stock company par and non-guaranteed elements, which will be coming to the foreground in the next several months.

MR. CLAUDE THAU: As Bob indicated, I am here to speak about stock company issues. My presentation will be broken down into three parts: the first part will provide an update of the status of various actuarial committees; the second part will give an alternative view of participating business in a stock life insurance company; and the third part will discuss other non-guaranteed elements.

The current SOA draft 13A has neither been agreed upon in committee nor released for exposure. However I've been fortunate in seeing a draft. There are changes which could affect mutual companies as well as stock companies. In particular, there are two areas in which I disagree with the draft. If there is interest, I could discuss these during the question period, so that you could look for these particular points in the eventual exposure draft.

Little has been resolved up until now regarding other non-guaranteed business. It would appear that the existing par draft would cover participating indeterminate premium business and that a non-par version is necessary.

The American Academy of Actuaries is doing little right now on these topics. After the Society of Actuaries publishes its principles, the Academy will change its guidelines, review its disclosure recommendations, review its recommendations regarding changes in Schedule M and discuss the "grandfathering" issue. The Society has determined that the possible grandfathering of existing participating business in stock companies is not a theoretical decision, but rather a political and practical decision that should be left to the Academy of Actuaries.

At this time the Academy Committee is not authorized to deal with non-guaranteed elements other than dividends. A change in its charter, its name and its make-up will be necessary in order to deal with these topics. For this we will need more stock company actuaries to join the committee.

The CIA has published a draft which applies to all companies registered federally, in Ontario or in Quebec. It is similar to the Society Guidelines. Foreign companies or companies registered in other provinces are not covered, nor are the non-guaranteed elements other than dividends.

Many other committees are also at work in this area. Of particular note, two actuaries who work with me, Mike Davlin and Shane Chalke, have written a paper regarding the application of the Standard Valuation Law and Standard Nonforfeiture Law to indeterminate cash value products whether they have fixed or flexible premiums. I expect that this paper will be discussed at the annual meeting in Washington at Panel Discussion 4.

Moving on to my second topic, a more moderate view of stock company par business is suggested by the definition of the word "participating". This suggests that both the policyholder and the shareholder should share in deviations from expected results. The policyholder's share is not found in companies which never update dividend scales. The shareholder's share is not found in the internal mutual company approach. Therefore we have a more moderate philosophy for stock company par business.

In such a moderate stock company, it is quite possible that the three basic tenets of mutual insurance are all violated. These tenets are:

a) provide insurance essentially at cost
b) each class highly likely to be self-supporting
c) divisible surplus distributed in proportion to contributions thereto.

Let's consider a sample philosophy as follows:

1) Each block has an independent contract with the shareholders
2) The shareholders share positive deviations with the policyholders
3) The shareholders absorb negative deviations up to the amount of expected profit in any given year
4) Each block of par policyholders is independent except for pooled experience factors

I won't go into detail as to why this kind of a philosophy questions these basic tenets as they apply to a mutual company. However the philosophy is appropriate for the par stock company. The principle that a business must probably be self-supporting, is totally out of place. Similarly, sound expense allocation, which is another cardinal principle, is unnecessary. Whether the insurance is being provided at cost or not is open to definition. I suspect that most mutual company actuaries would take the position that it is not being provided at cost. The contribution principle will not really apply as it is understood under some interpretations.

Moving on to other non-guaranteed elements, there are numerous features which may not be fully guaranteed at the expected level. These include premiums, dividends, cash values, death benefits and settlement options. The risks involved in these non-guaranteed features may include interest, mortality, tax, persistency, expense, etc.. Policies of non-guaranteed elements include traditional participating business and variable life. However those types of policies are frequently excluded in discussions of principles regarding non-guaranteed elements.

In discussing non-par non-guaranteed elements, it is necessary to distinguish them from policyholder dividends. The key difference is between prospective and retrospective analysis. At a Society meeting a couple of years ago, I spoke to an actuary for a state insurance department who said that "Not even God can tell if a change is retrospective or prospective." Not normally known as someone who is frequently speechless, I was nonetheless unable to marshal my mental forces in order to respond to that particular actuary. I was too distracted by the entirely foreign concept that God was unable to do something which I considered myself quite capable of doing.

Recent history indicates a substantially different impact on dividends than on indeterminate premium products. For example interest yields have been phenomenally high with the prime rate surpassing 20%. Largely as a direct result of that particular characteristic, policy loans have far surpassed all previous records. Surrenders are also at record levels. In determining our dividend scales for participating policies, we factor in all of that volatile experience. However in re-pricing indeterminate premium products, despite all of this radical experience, we do not expect these incredible results to continue. The past only impacts the non-guaranteed element products by affecting our future expectations.

A sudden catastrophe or epidemic would also have a much stronger impact in dividend scales than in the scales of indeterminate premiums. There are many other distinctions between non-participating non-guaranteed business and participating business, but the prospective principle is the key.

Actually, there are many philosophies regarding non-guaranteed elements other than dividends. Companies writing such business are not hampered by well-defined philosophies. There's nothing wrong with a philosophy that indicates that the premiums are not guaranteed but will never be lowered and won't increase unless a dire emergency occurs. The resultant savings in deficiency reserves and release from risk justifies a lower cost for the consumer. As long as proper disclosure exists, policyholders will be able to understand what they are buying.

Moving on to the regulatory environment, there are a number of issues which relate directly to non-participating non-guaranteed element plans. Ironically, with the possible exception of Variable Life, this is the class of product which currently suffers from the most regulation. For example, one of the many regulations regarding disclosure requirements indicates that the company has to identify the alternative premium for a fully guaranteed contract. I don't know what a company should do if there is no otherwise identical guaranteed cost contract.

In determining minimum cash values, some states require that these be calculated according to the slope of the non-guaranteed rates. Others require that they be calculated according to the slope of the guaranteed rate. Still others indicate that they should be calculated on whichever slope produces the greater cash values. It's worthy of note that to base cash values on the slope of current illustrated rates is similar to basing par cash values on the slope of net payments (net of premium reduction dividends.) Thus a traditional participating whole life policy would really be a decreasing premium whole life policy resulting in higher cash values under such an interpretation. Some states require that no prospective change in slope result from a revision.

In the area of premiums there are a number of requirements, the most significant being the requirement that assumptions, profits and all formulas be filed initially for current and guaranteed factors, and that for future revisions assumptions and rates be filed for approval prior to implementation. This approval process and the lead time which must be provided to the policyholder create significant practical problems in doing premium revisions. Whenever new business rates are changed, inforce premiums may have to be reviewed. Two states indicate that the class definition cannot change after issue. There are numerous other requirements. Most of the requirements would apply equally to all non-guaranteed policies, including participating insurance. That step has not been taken.

Federal regulations are also significant. In particular the IRS is considering several questions which would be unfavourable toward non-guaranteed element plans. This includes the "phantom premium" and related issues as well as possible denial of the non-par deduction.

I will close on this note. The SEC is also involved. My understanding from some sources is that the SEC is likely to label something as a security if the person who buys it is dependent to some degree on the performance of the company from which it was bought and if the company management have discretion in effecting the policyholders' results. If you think about it, is there a clearer definition of participating insurance in its traditional sense than that.

MR. ASTLEY: Thanks, Claude. Does the audience agree that the concept of disclosure to management has been accepted reluctantly? We have heard two different view points on mutual company par insurance. Do you agree that it is a significant issue whether so called proprietary information on dividend scales and on non-guaranteed elements should be available through regulatory authorities to your competitors? What are your views on the whole question of non-guaranteed elements? I invite any contributions in the form of comments or questions from the audience.

MR. JAMES F. REISKYTL: The disclosure to management should be adequate. They should be fully informed about everything that we are doing in regard to our dividends. On the matter of proprietary information I disagree with Dick. I don't know what help proprietary information would be to your company if they knew what our company was doing. Perhaps Dick would tell me where I am wrong.

MR. STENSON: There is no disagreement on the point that management should get full and complete disclosure. Public regulatory groups should also get appropriate levels of disclosure. Dividend recommendations which are an integral part of par life contract pricing, should not be publicly available due to their full details. The handling of products within the industry is generally different from company to company. In the long run this benefits the consumer. If your files are completely open and available to any of your competitors you would ultimately end up having a homogenized product.

MR. THAU: Until recently I thought that the question of the public disclosure of our assumptions was not important. Because of the requirements that many states have made on us, I have now been confronted with having to think about the issue much more carefully. I have found a number of areas where I believe the information is truly proprietary in nature. For example I would not like to be forced to disclose our smoker versus non-smoker mortality assumptions to our competition. Although State

Mutual was kind enough to publish their data, they shouldn't be forced to do so. If advanced and valuable income tax planning is done by one company they shouldn't be forced to disclose this to their competitors so that they can use the same information without doing the actual work themselves. Public disclosure discourages research and development if that work is immediately disclosed to your competitors. We have confidential reinsurance agreements with our reinsurers. The agreements we make with different companies will not be the same for all of them. The disclosure of the agreements could cause a few problems. In the last few years persistency has been found to be very volatile. Our company has a lot of increasing premium whole life business. I don't see why we should be forced to divulge our experience on this block of business to everyone else in the industry. The same thing can be said for optional elections. We may choose to make certain information available or discuss it informally at sessions such as this, but to be required by the states to make that knowledge public is unjustifiable and beyond the proprietary nature. Another objection is that complete disclosure will cause time delays in introducing new products or revising existing products.

MR. RUDD: A number of years ago the Canadian government statement gave the net rate on assets as well as the portfolio average return on the par fund. The dividend scale formula was also shown. It is no longer there because with the advent of computers, formulas became very complicated. The mortality profit, how it was computed, the interest rate used, and for a whole life policy the expense charges made were all shown. Everyone had their competition's rate manuals. From this they knew the gross premium. Therefore for years, we operated in a perfect goldfish bowl such as Mr. Reiskytl has referred to.

Another example is taxes. They became quite a competitive issue. The tax loopholes ended up in an explosion within the Canadian life insurance industry which forced a complete rewrite of the total corporate taxation of the life insurance industry. This resulted in a bad name for the industry.

I must agree with Mr. Reiskytl.

MR. REISKYTL: Although I would have no problem publishing my dividend resolution, I don't anticipate having to open the entire files of the company. I would agree with disclosure along the lines that Mr. Rudd has described. Any of the items which Mr. Thau mentioned do not show up in the dividend resolution. I am not going to show my reinsurance treaties or the way I treat taxes. There is nothing wrong in saying that this is what I have been assessed for taxes and this is my dividend interest rate. But I will not show you how I got these numbers.

I do not think that we have homogeneous society as Mr. Stenson indicated. There are differences in experience between companies and we cannot all afford to pay each other's dividend scales. In an environment with complete disclosure, companies would compete on an experience basis.

Mr. Thau, you commented that the non-par non-guaranteed product is the most highly regulated in the business. What do you believe is proper regulation once you leave the fully guaranteed traditional non-par concept. If the states didn't propose regulation who would regulate your activities? What regulations and standards should there be?

MR. THAU: The key element is disclosure to the consumer at the time of illustration. A company will have a philosophy on how they expect to handle a particular type of business at the time that they issue it. Some presumption has been made in pricing. They will know how they expect to treat it in the future. That philosophy should be exposed to the policyholder or the prospective policyholder. If a company does not state its philosophy, probably because it does not have one, a conscientious broker should advise the policyholder to be leery of the situation.

Then there is the much greater difficulty in ensuring that the company is in fact following the stated philosophy. Once it has been disclosed to the policyholder, they have some ability to raise questions themselves. If something is wrong, they can complain through their directors. Class action suits are possible against both stock and mutual companies. A better approach on the part of regulators would be for them to step in only if they have some reason to believe that manipulation is occurring. Indication of this could come from complaints from the public or from a required filing of rates with the state regulator. If the regulators saw new business rates for the company steadily decreasing and an abnormal growth of the inforce they would ask for additional information. Currently the efforts required on the part of issuing companies because of the types of regulatory involvement is simply a restriction on the consumer and the products that can be available.

There are some incredible regulations. There are rulings that if you change your premiums prospectively the prospective slopes have to remain the same as in your original pricing. There are at least three states saying that you cannot change the definition of your class after issue if you have a non-guaranteed element. However if you are a mutual company issuing par insurance you can do so.

MR. ASTLEY: Our company is currently facing a practical situation which could be of interest here. Since 1978 we have identified smokers and non-smokers separately on our computer files. We are now in the process of repricing our permanent insurance on a smoker and non-smoker distinct basis. How many believe that it would be improper to reflect that smoking and non-smoking distinction for this business issued since 1978 through the dividend scale? (About 20 to 25 people felt it was improper. There were approximately 15 who thought it would be permissible.)

MR. PETER F. CHAPMAN: I voted for the propriety of doing so because a participating contract obligates the issuer to identity all the cost elements and to use them equitably in pricing the product. This will however be very hard to do in a practical environment. The smoking and non-smoking distinction is being made via the premium scale. Persistency would not be encouraged by either cutting the dividend scale drastically for the smoker or by going back and increasing the premiums.

MR. THAU: I consider this question to be quite different from going from a portfolio to an investment year method. That is largely an improvement in equity which can result because of greater capacity. Changing the definition of the classes does not fall into the same regard.

Various companies are accomplishing this matter in various ways. One company is soliciting their healthy non-smoker inforce policyholders to rewrite their business. They feel that they are going to lose this business to someone else if they don't do this. The impact on those who were standard non-smokers at issue but are no longer, and on smokers who thought they were buying a product where they were going to share in the group's future experience could be substantial.

MR. STENSON: There are three issues involved here. They may be contradictory from time to time. One is the issue of pure equity. A developing difference of experience in a group of people should be reflected in the dividends. That is really what participating insurance is about. Then there is the concept of changing class definition after issue. Are the rules being changed after the fact? There may also be a legal argument. Lastly we have the issue of the practicalities of the situation. Even if a company does not actively go out and attempt to replace its non-smoker business, you might get the same effect naturally. This would basically turn the old class of business into a smoker class anyway. It is a complicated subject. Althought it was not done, non-smoker and smoker class distinctions could have been made at the time of issue. Therefore now it should only be done for new business.

Mr. Thau mentioned variable policies from time to time. Our company sells a variable life insurance policy. There is no call for additional regulation here because of the involvement of the SEC. The SEC requirements for variable life insurance are sufficient for the consumer to obtain a clear understanding of the product he is buying.

MR. THAU: I would like to comment on two areas where I had some difficulty in draft 13A of the Society committee on non-guaranteed elements. The first area has to do with shareholder charges. Section 10.3 of the Recommendation deals with the number of miscellaneous and usually minor final adjustments which are made to a dividend scale. This includes things like smoothing, pegging, grossing the scale up or down so it meets the total amount of surplus which is to be distributed and reflecting non-par elements if you are a mutual company and spreading these over your mutual policyholders. The shareholder charge is included there in the current draft 13A. This suggests that it is a miscellaneous final element adjusting the dividend scales. This treatment does not give the shareholder charge its proper significance. There should be a separate section on it. In fact the charge is an integral part of many stock companies' dividend scales. This section should include the principles involved in determining that shareholder charge. For example, it should state that the variables that determine the shareholder charge are not to change after issue.

The second issue deals with the recommendation requiring a separation of accounts for lines of business and within these lines between participating and non-participating business. There is no theoretical basis for requiring a separation of accounts. However there are practical political reasons why this may be necessary. The Society nor the Academy should be stating a theoretical need where it is really a practical or political one. For example, in the situation of a stock company where an asset-share approach is used to determine the dividend scales, there is no need to have a par policyholder account. For non-regulated companies this is really a misnomer because under generally accepted accounting principles, that surplus belongs to the shareholders and not to the policyholders. It is misleading to have a par policyholder surplus account if that is not what it really is. It is ironic that this area has the strongest wording throughout the recommendations. In most cases the recommendations talk about what is usually done or should be done. The statement on this subject which uses a much stronger language than elsewhere is saying that it is required. At the very least this should be changed to usually. Part of my concern, if this requirement is included in the guidelines for par insurance, is that somebody would immediately apply the same thing to non-guaranteed elements and create additional lines of business. The argument for having a separation of accounts between par and non-par totally breaks down when you get to non-guaranteed elements. Any accumulated surplus or loss is non-participating by definition and borne by the policyholders. The non-guaranteed elements are determined totally prospectively. Therefore there is not need to have a separation of accounts for this particular business.