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DIVIDENDS AND OTHER NON-GUARANTEED ELEMENTS IN INDIVIDUAL LIFE INSURANCE AND ANNUITIES

Moderator: HARRY D. GARBER. Panelists: RICHARD S. MILLER, WALTER N. MILLER

The Society Committee on this subject has distributed an Exposure Draft to the membership in advance of the meeting. Topics include:

"Recommendations Concerning Actuarial Principles and Practices in Connection with Dividend Determinations and Illustrations for Participating Individual Life Insurance Policies and Annuity Contracts"

"Recommendations Concerning Actuarial Principles and Practices in Connection with Individual Policies and Contracts Containing Non-Guaranteed Charges and/or Benefits"

MR. HARRY GARBER: This is an open forum and that means we're more interested in your comments than in having members of the Committee talk. Our comments will be brief, and then we'll open it up for questions and discussions.

We sent out, in advance of the meeting, an Exposure Draft of the report of the Committee. If you've read it, you will understand more of what's happening. If you haven't read it, I hope that today's discussion will encourage you to read it.

The Committee on the Theory of Dividends and Other Non-Guaranteed Elements in Life Insurance and Annuities is not a regular standing committee of the Society, but is a temporary one. We've been temporary for six and one-half years and I have told the members that next year is our last year. Ed Matz was the original chairman, Ed Lancaster followed and I took over the chairmanship two years ago.

We started with concerns about the quality of and the discipline on dividend illustrations. These concerns stemmed from (1) the development of the IYM method of allocating investment income and (2) the report of the Munson Committee which showed that the dividend practices of mutual companies were considerably more diverse than anyone had imagined. We started by trying to confine our work to dividend illustrations, and found after considerable effort that we couldn't do that. Accordingly, we adopted an approach which involved the development of a theory of distribution of dividends on existing business first and then tied new business illustrations to those existing business dividends.

The Committee issued a Proposed Opinion in 1978 and Recommendations in 1979. We thought that we were ready to go out of business at that point, but we were asked to stay on to work with the Academy Committee whose charge was to review, revise to the extent appropriate and implement the Recommendations. Also, our Recommendations hadn't dealt with the participating business of stock companies and that stayed on our agenda. During the next year we refined our Recommendations and worked with the Academy Committee on implementation of theirs.

In 1980 the Committee was reconstituted to deal with two subjects: (1) the participating business of stock companies and (2) several types of coverages encompassed under the general title "Non-Guaranteed Elements of Individual Insurance and Annuities". That title covers universal life insurance, policies with indeterminate premiums, excess interest policies and so forth. These new forms, while not participating business in the traditional sense, have elements that are similar to participating business.

The Committee has always endeavored to obtain the ideas and opinions of all members of the Society. We've had a session at the fall meeting every year except last year. We want to hear from you today or, if more convenient, please send us a letter with your thoughts in the next month or two.

In the last year or two we have defined better the roles of the Society and Academy committees on this subject. The Society Committee is principally concerned with the theory of what should happen. We should be setting the ideals, the goals, towards which actuaries should strive. We know that there are practical limitations, in many cases, but the degree to which they should be incorporated in Recommendations is primarily an Academy matter. Our Committee isn't seeking to wash its hands of the practical, implementation problems (and we do have many suggestions to pass on to the Academy Committee in this respect) but we must not let this get in the way of our primary function of defining the applicable theory.

Our general approach has been to neither prescribe nor proscribe the actions of actuaries or companies. We tried to define accepted practices and ensure that actuaries will prepare a report to management that discloses any departures from these practices. Disclosure is the key to what we have proposed.

One other matter is the question of antitrust law. Some of you may have seen a Supreme Court case this spring concerning the actions of an organization of professional engineers that was charged with setting standards of one sort or another. The Supreme Court held that the organization had violated the antitrust laws in that process because they had created situations in which one or more companies could not compete effectively. This made our Committee a little uncomfortable and at the suggestion of the Society's counsel, an opinion of outside counsel was sought. While we never will receive a clean bill of health on this question, we are satisfied that we are on a track which probably will permit us to stay within the antitrust boundaries.

Finally, one question that did come through in the letters we received before the meeting is, "Why is the Society doing any of this?" This is an important question and the purpose of this inquiry has not been stated as explicitly as it should have been. Outside counsel who have reviewed this activity believe that we should be very specific as to why we are doing this and what its boundaries are. They have suggested a paragraph which I will read as a matter of interest. This has not been accepted by the Committee and I'm sure that when you see this paragraph in our final report it will be different.

"Actuaries, as members of a profession, have a professional responsibility not only to insurance companies but to the public that purchases insurance products as well; accordingly the Society members do not wish to assist or participate in practices that may be inequitable to or deceive purchasers of life insurance or annuity products. On the other hand, the Society recognizes that flexibility is important in sound actuarial standards and that the decision of what charges or benefits to declare is exclusively within the discretion of the insurance company. Accordingly, the Society is promulgating broad principles which it considers to reflect accepted and fair practice. The only requirements of the Recommendations are that the actuary submit a report to the insurance company and if he deviates from the principles stated therein, that he disclose that fact to his employer or client and explain his reasons for doing so."

I will now call on my two panelists and then we will go right into the general discussion.

MR. WALTER MILLER: The contributions of the Society membership on a subject this important is absolutely vital. We know we're going to learn a lot today; we know we're going to get a lot of good suggestions. The one request that I would make is, to the extent possible, please be specific in your comments. If you have a deep-seated feeling that the report is just no good and ought to be thrown out, you have the right to express that opinion and it should be registered. But in the spirit of trying to make progress on this very important issue, to the extent you can offer specific comments such as "I believe Section X is deficient because ..." this will be much more helpful to the overall effort.

The most recent development in this area was the formal adoption by the Academy of Recommendations to apply to traditional participating policies which, as Harry indicated, were based on a previous draft prepared by this Committee. As indicated in the preface to our Exposure Draft, we have now made some significant additions to do what, in our view, was the right thing to bring in the par policies issued by stock companies.

In our exposure draft there are also two new paragraphs towards the beginning that you won't find in the Academy document, but we thought they would be appropriate in the spirit of refinement and amplification. The first appears under the Contribution Principle as a second paragraph in Section 2.1. (The first paragraph defines that principle in the same words as in the Academy Recommendations). "In its pure form the Contribution Principle applies to each year's divisible surplus. However, the Contribution Principle can also be related to the divisible surplus over an extended period of time when constraints on divisible surplus or the dividend distribution system prevent the application of the Principle each year. In such event the procedures which lead to the longer term operation of the Contribution Principle should be described in the actuary's report." One thing this means is that if your company has to make a specific reaction to a one-shot type of situation, that doesn't necessarily throw you off the Contribution Principle forever but it certainly is something that should be commented on in the report. The second addendum is a new third paragraph in Section 3.3 following descriptions of some of the methods of dividend determination that have been around. "It is the application of a particular method, by means of the experience factors, which determines whether or not it follows the

Contribution Principle - not the method itself. Also, it may be that a particular method which does not of itself satisfy the Contribution Principle will do so when termination dividends (see Section 11) are taken into account." This speaks for itself.

As explained in considerable detail and (I hope) in understandable fashion in the preface to the report, the Committee felt that in order to have these Recommendations embrace par business offered by stock companies there were two key additional factors that had to be put in this Exposure Draft. The first is that if it's par business the Contribution Principle should apply because, in terms of basic principles, the Contribution Principle should apply to par business wherever that business comes from and under whatever circumstances. The second reflects the Committee's feeling that in order for this to happen in a stock company environment there should be in operation properly segregated accounts for the par branch of the business and there should be a limitation on the amount of earnings of this branch that can be diverted and used for general and corporate purposes.

Now when you talk about par business issued by stock companies, very obviously you are dealing with an extremely broad spectrum. In some cases, you are talking about policies that are absolutely indistinguishable in every respect from par policies offered by mutual companies. In other words the company always intended to have a dividend distribution system under these policies which reflects the same principles as those used by a mutual company . At the other end of the spectrum you find policies that are par in name only, and I'm not trying to suggest that this is improper because plenty of sound coverage has been written in this form. But because it does contain the dividend mechanism and because state insurance laws are what they are in terms of some of their definitions, these policies have always been called par even though they have never been intended to operate and have not been operated under some or all of the principles applicable to par policies offered by mutual companies. I'm not offering a value judgment there; I offer it as a statement of fact. I'm not trying to characterize it as good or bad.

How then do we get everything under one umbrella? Or perhaps the important question is how broad should the umbrella be? This is a critical and tough question. It is exceptionally tough because if the Academy Committee follows the route that it did with its prior set of Recommendations, there seems to be a good chance that it will recommend disclosure and that might be felt to be rather rigorous or onerous by the affected companies. So the question of applicability is a key one. From the standpoint of the Society Committee our report says that we considered three main approaches. First, to say that these principles apply to all par business no matter where, when or how it emerged. The second would be to say they apply to companies or to policies where it has been intended that the system follow that used for traditional mutual company par business. The third is a phase-in approach under which the latter condition might exist at the outset, but commencing on a certain future date the principles will have broad appliciability. The Committee concluded that from the standpoint of actuarial principles, the only proper solution was to say that these principles applied to all par policies. We recognize that is by no means the end of the story and we're not intending to suggest that, when the Academy gets hold of our final product, its only proper course is to have these Recommendations apply across the board.

To help lead into the discussion aspect of this session, let me close by mentioning a letter recently written to Harry by Bill White, who is Chief Actuary of the New Jersey Department and obviously one of the very interested and very knowledgeable people in this area. Bill's letter is long, and we're going to try to convince him to agree to have it printed in its entirety in the records of this session. I think a lot of you might be interested in writing or calling Bill and asking him for a copy of this letter (note - the letter is included later as part of the record of this session). It would be worth your while; it's a good meaty letter. I'd just like to quote a couple of things from it that I consider to be particularly relevant. Perhaps the most important one is his very first sentence which says, "The Committee deserves the unqualified thanks of our profession, the industry and regulators for an outstanding report on dividends and other non-guaranteed elements." Some of you who read the letter may feel that there is other material in it that is more important than that. (laughter)

Let me just quote a couple of things here. I gave you the list of three approaches that we considered to the question of applicability, and Bill thinks there should be a fourth. He says "The Committee seems to have concluded that companies should be entitled to classify their business as 'participating' and their distributions as 'dividends' even if there is no intention to adjust the illustrated figures to reflect actual emerging experience..... For our profession to condone the use of 'dividends' to refer to non-guaranteed coupon or endowment benefits might lend credence to these criticisms. My, (Bill White's) fourth preferred alternative approach would be: Design the recommendations to apply to all companies, but limit the use of the words 'participating' and 'dividends' to instances where fundamental participating principles can be met; in all other instances the company should be prohibited from using those or like terms, and should be fully subject to the Recommendations for Policies Containing Non-guaranteed Charges and/or Benefits". That's an interesting comment. My personal reaction, after not too much reflection, is (a) that's probably a matter for the Academy Committee, and (b) I wonder about the feasability of it in view of the current status of state insurance laws, some of which are changed less quickly than others.

One other comment of Bill's is one we may legitimately hear from many of you. The theme is that perhaps time has passed us by because, in effect, we're largely adopting wording which was developed for the current Recommendations. Bill White points out that different things are happening. He points out correctly that: "Direct recognition of policy loans (the four-factor dividend approach) and segmentation of assets for dividend classes (the Attwood-Ohman paper), are new since the original report and are close to being generally accepted actuarial principles. I can interpret the existing recommendations as embracing these concepts, but I wonder if it would not be wise to spell them out so as to avoid uncertainty." My personal reaction is that we're in such a dynamic situation that there are probably a number of areas where periodic updating is necessary. I would hope that unless there is something radically wrong with our current draft, we could agree to take the next step forward on the basis of the prior definitions. Otherwise, we may never get to take that next step.

MR. DICK MILLER: I get the short end of the stick here because I get to describe the parts that everybody's throwing tomatoes at. Our transition from 13A to 13B was an attempt to incorporate all of the other non-

guaranteed elements, whether issued by a mutual or a stock company, that have emerged in the marketplace in the last several years. In doing that, and primarily with reference to stock companies, we found ourselves faced with the introduction of a new conflict between the interest of the policyholder and the interest of the company. In the mutual company situation, we presume these interests to be, in the long run, identical, but in the stock company situation there is interposed a separate risk taker whose interest may be at diversity with the policynolder. There is an overriding concern that the policyholder can know the facts when a policy with non-guaranteed elements is issued. To quote from page 6 of our report, "And in this respect, the buyer of a non-guaranteed premium policy or a policy involving excess interest credits or other non-guaranteed charges or benefits should be in a similar position to the purchaser of a traditional participating policy issued by a mutual company". This specifically refers to being able to make an informed judgment in the purchase of the policy. Six and a half years ago, that was the original concern, that was the original impetus, that drove the formation of this Committee. It still is and applies directly to these policies.

We introduced a new principle in actuarial literature, the Continuity Principle. All that is required, if non-guaranteed charges or benefits are changed, is that such changes be based on changes in the underlying experience. The customer should expect no less when charges and benefits are not guaranteed at issue. But we did not make this symmetric, we only required documentation of underlying experience change when charges or benefits are changed. We do not require that charges or benefits be changed when there is a change in the underlying experience. That is a deliberate avoidance of some of the problems you can get into. We introduced the prospective view of expected experience. As a stock company actuary, I very strongly felt that it was a prospective viewpoint which drives most, if not all, of these determinations. Divergence from actual, realized experience can be quite dramatic when the expectation of future experience leads one into some difficult "least costly" decisions. The equitable distribution of realized experience deviations which may occur under this context have no direct bearing on the equitable distribution of realized experience which underlies the Contribution Principle of dividend distribution.

Then we have a question of past losses or gains. The tie vote of the Committee, which is enlarged upon in our report, must be commented on. The cynical view emphasized the tax aspects of this position, both from the standpoint of the stock companies wanting to make certain that these items were not classfied as dividends and perhaps in the mutual viewpoint of wanting to be able to do the same thing. Some of the Committee wanted to charge experience losses and therefore advanced a reference to past, and very common, practices established with respect to individual health insurance. The analogy there is very telling.

In the case of past gains, one illustration which may bring the question into clearer focus, is the practical impossibility of telling your management that realized gains which were reported in the last quarter's earnings statement, and paid out in cash dividends to the share holders, must be regurgitated because they have to be returned to policyholders. That's an impossibility.

Then we made a drafting decision to track 13A. For mechanical reasons, and to touch all bases, the Committee has agreed with this procedure. Every so often we have a situation arising where policy decisions might render the pertinence of a particular paragraph very suspect when you apply a prospective viewpoint or a "no distribution of gains or losses" concept. I apologize for leaving those in, but the alternative of dropping them out would have been even worse.

Now the controversial points. There are two obvious points to comment on. One is the tie vote. To my knowledge, and I've been on the Committee since its inception, it is the only time that you can clearly categorize the discussion, debate or vote in the Committee as polarizing on a stock versus mutual basis. There were obviously many questions which affect stock and mutual differences, but I doubt we ever had an absolutely unanimous stock vote as we did then. I don't want to preempt any of your comments but I do want to set the stage by reading the offending sections 13.1 and 13.2.

Section 13.1 reads: "An important question is the extent to which substantial amounts of accumulated loss on a policy class should affect redeterminations of non-guaranteed charges and benefits. There is no question that future charges and benefits should reflect the experience anticipated in the future, even though it is worse (or better) than originally expected. But, a company should not seek to recover past losses in redetermining charges and benefits. The provision for profit and risk is intended, among other things, to compensate for undertaking the risk of loss, so there is little basis to seek to recover past losses in redetermining non-guaranteed charges and benefits. However, for fully participating business the company may seek to recover past losses or distribute past earnings. If this is done, the principles and practices of the Recommendations dealing with policy dividends should be followed."

Section 13.2 reads: "RECOMMENDATION 15. The Actuary's report should disclose whether redetermined charges and benefits for non-guaranteed policy elements contain an explicit provision for the recovery or distribution of past losses or earnings and the amount of such provision." The Committee urgently urges your debate on the questions of these paragraphs.

The second controversial point is Bill Rudd's Minority Report which immediately follows Recommendations 13B in the Exposure Draft. Bill's questions, to a large extent, deal with proper attention to some of the items that fall into the crack between the Society Committee and the Academy Committee. In fairness to him, I'd like to cover at least a couple of what I feel are his major points. "As respect to participating business of a mutual life company the actuary, senior management and the board of directors are all responsible to the participating policyowners who elect the directors. When the actuary discloses deviations, presumably senior management and the board are aware of the possible consequences. Disclosure is thus an effective operating discipline." However, the member should satisfy himself that the persons who requested his report are fully cognizant of the significance of his findings. Also, Bill is concerned that there has been a reluctance to provide for disclosure in the actuary's report of differences between actual experience and applied experience factors.

As respect to stock company participating business, although the report recognizes the necessity for limitations of shareholder take indirectly or directly, Recommendation 13A does not. Bill believes the Recommendations should follow the CIA approach leaving to the Academy the question of unregulated stock companies.

As the last item from Bill's comments that I'm going to emphasize, "our work would seem more appropriate as guidance to regulators and the industry than for the profession but the Recommendations and report do not bring this into focus."

Another item which has occurred to me is that even in a stock company issuing no business which meets the desired standards for use of the term "participating," there probably is some kind of executive committee or board ratification of annual recommendations on traditional supplementary contract interest rates. This established cycle of activity does not exist with respect to the products we're discussing in 13B. Indeed, annually may the exceptional cycle on these products. Moreover, the decisions on these products may involve the actuary as little as just in the execution, or as much as in the responsibility to initiate the debate. The report contemplated simply does not seem relevant in these circumstances, except as an after-the-fact documentation. The fate of most admonitions on documentation is well known.

We've gone a long way toward asking for extension of legislation defining participating business, both into more states and in the detail of review by the regulators of our actual actions. The marketplace may let me avoid issuing a participating line of business, but the similarity of 13B to 13A in this respect gives me nightmares.

The implications of the Continuity Principle blinders to the situation in other policy classes are particularly troublesome when a policy class is closed and a new similar one is simultaneously opened. Perhaps more to the point may be whether there is a question of unfair discrimination within the fair trade practices laws. Indeed, the whole question of rate book consistency or cross-section comparability may be one for the lawyers and not actuaries, since it will almost certainly be settled in a class action suit in court.

The Society of Actuaries' lawyers suggest that the Continuity Principle should be applied only to require disclosure when a breach results in adverse action from the policyholders' standpoint and would change the wording to require disclosure even if an adverse action was supported by an adverse change in anticipated experience.

Finally, I have a recurring feeling, a vague uneasiness that comes and goes, that the Committee has been talking among itself much too long. We've tried to get your input, but we may have gotten completely out of touch with hard reality and our work may be largely ignored in practice and may rank with Don Quixote in its length and futility.

MR. WALTER MILLER: I'd like to get just two more excerpts from the Bill White letter into the record right now. These touch on this important question of past losses and, as I should have said before, Bill naturally had to warn us that these views are his own and not necessarily those of the New Jersey Department. Bill says, "If a company routinely anticipates

increasing its profit or risk factor in order to recover past experience losses for a block of business, then that business is participating, and the company should similarly reduce those factors in order to return more favorable experience than originally expected. In other than those situations, it would seem clearly inappropriate for the non-participating business of a stock company to be permitted to increase rates so as to recoup past losses." Later in the letter, as an addendum to that, he says, "Clearly, however, increases in profit and risk elements must be permitted, when the alternative is insurer insolvency. At this point, the actuary's responsibilities are to ensure (i) that the increases are applied equitably to all classes of business and (ii) that the amount of increase is commensurate with the amount necessary to restore or assure solvency."

I agree with both of Bill's points, and as a matter of fact, it was reading the first of those that has caused me to switch my prior position and, unless somebody else has switched the other way, it's not a tie vote anymore in the Committee. For whatever it's worth, I am now willing to go along with the view in the draft on past losses.

MR. GARBER: OK, let's open the forum for discussion. Give your name, rank and serial number when you come up. John Harding wants to tell us we shouldn't give him all these problems.

MR. JOHN HARDING: Well, I do think there is a technical word for your having determined the issue for the participating business of stock companies. The technical word is punt. And it gave me some measure of ill ease at first, but I think you're right that the principle is pretty clear and now the Academy should find for this country and CIA for Canada the appropriate ways for dealing with that issue in appropriate jurisdictions. I would also, however, like to, after praising you for a very fine job in getting a lot farther this year than I thought you would, make a comment with respect to the Continuity Principle. To quote Bill White again, if I might, and this quote would be from the paper he wrote earlier this year on universal life. One of his concerns could be labeled bait and switch. My concern is that the Continuity Principle allows the illustration of a much more competitive product than is intended to be the result. Essentially you can, as experience gets better or worse over time, change your experience only on the down side. You essentially ratchet your prices back down to where you intended them to be or back up to where you intended them to be. And maybe you've seen how to get around that, but I have not. My last comment is simply that it is now time for the Academy Committee to start working very hard in terms of dealing with both your Recommendations and with the comments received from Society members. To do that properly, I believe it appropriate for the Academy Committee to have its membership expanded to reflect more interests than are now represented on that Committee, particularly on the stock company questions. If there are any of you who are interested in serving with the Academy Committee, please let me know. That's all I'd like to say at this point. Thank you.

MR. GARBER: Thank you John. By the way, I will comment if it seems appropriate as we go along.

MR. GARY CORBETT: I have a few miscellaneous comments. Two of them get to the heart of these hard points. Until you explained it, I had misread the bottom of page 6 which talks about the purchaser of non-guaranteed policies being placed in a similar position to the purchaser of traditional par policies. I gather that means with respect to disclosure and being able to understand what's going on in the policy. That wasn't at all clear to me when I read it, and even when I reread it now I have to certainly struggle to make that interpretation. It's a bit of a bald statement that might hit some people the wrong way. It sounds like it would be in contradiction to the position that past losses should not be distributed because that would put them in a similar position. That's a small point.

MR. GARBER: Our lawyers also think that statement should be deleted.

MR. CORBETT: I have a question about an interpretation that relates to capital losses and investment income. When I read Section 7.1 together with Section 7.4 which talk about investable cash flow and the investment income experience factor, I assume it is permissible to take into account capital losses caused from negative cash flow from policy termination; that is, to spread those over the remainder of the group. I'm just not entirely sure of that.

MR. GARBER: Where you are forced to sell assets as compared to when you sell them voluntarily?

MR. CORBETT: Exactly.

MR. GARBER: I think that is a point that we really haven't considered. Maybe we should read it in but I don't know that it was put there deliberately.

MR. CORBETT: Those are the noncontroversial items. Now if I could come to page 9A and transfers to the non-par account. Maybe some of this is just a lack of understanding, I'm rather late into this game. In a couple of places it says that, ordinarily, transfers in excess of some modest levels should not be made if they were to impair the company's ability to maintain current dividend scale. Yet in other places, it implies that one is not entitled to change a risk charge, that it should remain relatively constant. Well surely if experience deteriorated to a great extent, you should not maintain the dividend scale. In order to keep the same risk charge going to the company, you would have to reduce the current dividend scale.

MR. GARBER: Let me put a little background on this whole subject. The Committee agreed that there should be some limitations, but we could not find a satisfactory way to establish a limit. The stock company people feel that the New York law or a law similar to it simply should not be put in this document. At one point we considered saying, well let's use 10% of earnings as a limitation, that's a reasonable number. They said no, you shouldn't even say that. So the end result was that we included things one might look at in lieu of a limitation. The interpretation on that sentence was that if an increase in the withdrawals from the policyholder account would in and of itself require you to diminish the dividend scale, that would be a factor that one would take into account in determining whether or not the transfer were reasonable.

MR. CORBETT: I realize this disclosure is only to company management. This gets into some of what Bill Rudd has written. I have the feeling that anything adopted is going to become practice, and might become a basis for disclosure to others.

MR. GARBER: On the point of transfers to the stockholder account, we welcome any comments as to what would constitute reasonable standards. To every idea the Committee came up with, someone said, no that is not reasonable.

MR. CORBETT: One of the measuring sticks or comparisons appears to be the amount transferred to the stockholder account, or the non-par account, as a percentage of distributions to policyholders. The only problem I have with that is if you have a low premium, low dividend philosophy as opposed to a high premium, high dividend philosophy, you should have higher risk charges. Yet if you do, that makes it look as if you're taking out proportionately more. But actually, the lower your dividends and the lower the premiums the more the company is really entitled to take because they've got more risk than in a high premium, high dividend plan.

Mr. DICK MILLER: Gary, I've got to bring up the point that has been bothering me for six years. You alluded to it and I think you're eminently right that there is a tremendous power behind these Recommendations to regulate or dictate practice. That is not what they are going to do, they are going to require disclosure. I fully expect, and intend to state to my management, that some practices we use do not in any way, shape or form correspond to the Recommendations for several and sundry valid reasons, and that will satisfy the situation you are talking about.

MR. GARBER: Gary, the level of a transfer is not the important thing, it's a question of whether there's a material change in that level over what it has been. It's not that the level is high or low necessarily, but that there is a material change and that is what you would report.

MR. CORBETT: I realize it wasn't a direct implication of that I was concerned with.

MR. GARBER: It's not intended to be an implication, it's really that if you made a big change, you should report it. It's something you have to look at and it isn't of itself a significant item.

MR. CORBETT: The last point is on the obvious one of the past losses in Sections 13.1 and 13.2. The statement is made that provision for profit and risk is intended, among other things, to compensate for undertaking the risk or loss, so therefore there is no reason to recover past losses. Well, I suggest that that is a pricing decision in and of itself. You can construct a policy that needs lower risk charges if you are willing to either return excess profits or recover past losses. It will change your risk charge to make sure that risk becomes different in that case.

MR. WALTER MILLER: Would you agree with Bill White when he says that the case you describe becomes a participating situation? There's a two-way street possibility in the case you've described.

MR. CORBETT: Yes Walt, they do take on aspects of participating policies when that occurs. This is a difficult question because it gets into taxes and, frankly, the reason many of these policies were developed is to permit companies that were in certain tax positions to write what were essentially participating policies. But I'm not sure if there is anything wrong with that. My main concern relates to the one concern the antitrust people had when they reviewed this. If you do not permit companies to recapture losses, their actual risk increases and that leads to higher prices. And that could really happen. My concern is I don't think it is a point of actuarial principle. I guess that is the bottom line for this group. I really think that is a company decision and not something the Society should be telling us that we can or cannot do.

MR. DICK MILLER: I want to emphasize the point that we have defined or attempted to define what has to be reported, not what has to be done.

MR. CORBETT: Let's hope it stays that way.

MR. DICK MILLER: I agree. That is the attempt of this Committee. In the minds of at least a number of the Committee members, the treatment of past losses is the way it is because they felt we have to recognize reality.

In health insurance, and more recently with respect to indeterminate premium policies, it has turned out to be a principle that has been reflected in a number of state regulations. Now, as a number of you have heard me urge before, there is only one way to avoid this sort of problem and to avoid having to come to the very difficult judgment on the legitimate point raised by Gary. Is this really a matter of actuarial principle? Do we have to talk about it at all? The only way to avoid this sort of situation in the future is for the actuarial profession to move faster to fill these vacuums ourselves. Let's not get into situations where we even have to talk about the necessity of saying that something is an actuarial principle because it's in all these state laws already. The only way to avoid that is for us to move more quickly and fill these vacuums, and there is a great vacuum right now in the area we're discussing, or they are going to be filled by others and create more problems.

MR. CORBETT: Dick, if you're giving away past losses you are concerned about going back and taking money that has been distributed to stockholders. I really think if you had a set profit margin risk charge, you could set up a reserve for future premium reductions, let's call it that. It's being done in other things to get away from that problem.

MR. DICK MILLER: That contemplates an a priori approach.

MR. CORBETT: Yes.

MR. WILLIAM TOZER: I am disappointed that the Committee took the third alternative on the 13A situation. From a stock company standpoint, I wish the position had been taken that these are the rules in the future rather than in the past. Stock companies are in a different position than mutual companies in two situations. First, some of us had actually, as Bill White alluded to, prepared products with the dividend scale in them as a non-guaranteed benefit. And really until the last two years, the only way you could put a non-guaranteed benefit in a contract and get it approved by an Insurance Department was through the participating route. They

weren't approving any other type of non-guaranteed benefits. Secondly, there are lots of stock companies that have purchased other companies with blocks of participating insurance in force, and the purchase price and considerations given in purchasing them were the profit margin, so to speak, in that participating business. That is a problem that mutual companies really do not have.

MR. GARBER: Bill, if the Committee had voted on the matter of what to actually implement, they probably would have agreed with you. And, if the Academy Committee asks us, that's what we'll tell them.

MR. WALTER MILLER: It is important to recognize, please, that we favored the first alternative in the Society of Actuaries context, where we were talking about actuarial principles and we had to deal with just one principle. We are not telling the Academy Committee that we think that that's what they should do as far as applicability. The preliminary remarks here indicate how onerous that would be. All we're saying is that we think the issue should be decided at the Academy level. And I certainly support what Harry just said as to the approach that our Committee probably would support at the Academy level.

MR. TOZER: I am concerned that your attempt to track 13B along the lines of 13A could create some real problems and dangers. In discussion here, and in discussions that have come up in other meetings about non-guaranteed products, there is a tendency to compare par products and par concepts with non-guaranteed items. By making the Recommendations parallel, we may be encouraging that comparison and I think that creates confusion rather than clarity on the issue. I'd also like to emphasize that, as Dick mentioned earlier, this Exposure Draft calls only for a report to management. However, we stock actuaries, I think, are going to get an unpleasant reaction from stock management. When we bring this issue up, they are going to say that those ivory tower actuaries are now telling us how we ought to run our business. And this approach is not going to promote the actuarial profession in a stock company environment. We can say all we want to about the fact that this is just to disclose to you, as management, that we are doing something differently than is normally done. But no matter how much we talk, they are going to get the interpretation that anything that is done other than the normal is really a slap in the face at the way that company is doing their thing. No matter how much you try to overcome that, I am afraid, that is going to be the basic reaction of a lot of stock management.

MR. WALTER MILLER: Is there anything at all that we can do to set up principles that wouldn't provoke that reaction?

MR. TOZER: Yes, I think so, Walter. I'd lean more toward some of the approaches that have been discussed on non-guaranteed items that are similar to what you have here, but rely more on not changing the rules from what they were at the time of issue. Now I think that is basically what you are saying here. But I think it is saying it a little differently, because I think what you are saying here is built upon the dividend contribution-type principle, rather than based upon a stock company actuary's approach of saying, I changed my premium scale and I changed it basically because the anticipated assumptions have changed and these are correct anticipated assumptions now. I'm not opposed to doing that. I'm more concerned about the way it's coming across.

MR. GARBER: Bill, that's exactly what this says. You described precisely the way it reads. On your concern about the parallelism of language in 13A and 13B, any specific comments you have would be very helpful. It was a practical step to try to use some of the same language. I think where we overlap language it is really in areas that are common, but we may have slipped up. We'd appreciate any specific comments.

MR. JIM REISKYTL: Harry, I'm not going to take this opportunity to comment on the draft. But I would like to ask those who do comment on the past losses issue or any other items to also comment on how they would define non-par. The Committee struggled with this. Possibly the lack of ability to recover past losses is a way of defining non-par. It would follow that if you prefer to have the ability to recover past losses, then you have a par product, well pseudo-par anyway. These issues have been discussed in some length and they are tough questions. We have the same challenge on what is a dividend. If when you comment you can go on to say what you believe non-par is and how you're going to make a distinction that would be very helpful for us on the Committee. What is the underlying concept in your mind, particularly stock company actuaries?

MR. HANK RAMSEY: I wonder if we don't need to scrape around for some other term. That is, as soon as you say par product or dividends it raises a specter. It is a thing that mutual companies have always done. And when you say non-par you get another vision. But they aren't very clear in terms of principles. If you could find a term which deals with intent - what is the intent of the company when it puts forth a product with elements that can be varied after issue as to how it is to operate with respect to that intent. If there is a means of dealing with that intent, that may be easier than dealing with definitions of par or dividends. It might be helpful in trying to come to grips with this most basic issue.

MR. WALTER MILLER: Intent to follow the Contribution Principle, intent not to follow the Contribution Principle, that just popped into my head, is that something to play with?

MR. GARBER: One of our problems is that we don't want to restrict the definition of participating in a way which would conflict with state laws. Where state laws call something participating, it's hard for us to call it something else. And we can't decree that if your dividend practices don't follow these principles, then you are no longer participating. That is not within the power of this Committee or the Academy Committee or anyone else.

MR. DICK MILLER: What we were dealing with brings us up against the stone wall of recent practical experience. For example, actual earnings may bear no relationship to interest rates that are declared. So what the marketplace will let you do, or forces you to do, has so much more strength in many situations than more calm-time actuarial principles. It colored my thinking in going through this.

MR. BILL CHEN: I had a few concerns with this report, particularly in Recommendation 13B. The first concern, which has been expressed by Gary and others, is whether universal life should be considered a participating contract or a non-participating contract. When I read the Committee report (page 7), it says the Committee started with the conviction that there should be an appropriate relationship between the non-guaranteed charges and benefits and the underlying experience of the company. And at the same time, Recommendations 13B (page 8B) say you cannot recover past losses. It seems to me these two statements are inconsistent. I think we know from the tax point of view that a policy is generally considered participating if it is experience rated, discretionary, or in a policy form. So I feel the Society should not judge whether a policy is participating or non-participating.

MR. GARBER: I'll try to respond to that. We considered two approaches to the relationship between experience and charges and benefits. There isn't an inconsistency now because we did not follow one of these approaches for that very reason.

MR. CHEN: The second concern is about the actuarial report. Recommendations 13B say that if you want to adjust benefits you've got to have experience based on mortality, persistency, and so on. It's very similar to health insurance, where they require an annual report to justify your loss ratio if you want to adjust premiums. So I have a strong concern that this might lead eventually to regulation of life insurance rates. I feel our Society should not do this to the industry.

A third concern is that Recommendations 13B do not apply to a contract which is subject to an outside index. And we know, right now in the market there are universal life policies with an index. Generally, contracts are indexed three years. I don't know what you are going to do during the three years that the policies are indexed.

MR. GARBER: This was to cover variable life and those other policies that are indexed. Once a policy stops being indexed, it goes to a regular status at that point. Recommendations 13B don't apply to the indexed element, but may apply to other elements in the same policy.

MR. MIKE DAVLIN: I promised an associate of mine, Claude Thau, that I'd bring along with me a commentary and a questionnaire that he prepared. He's been following this issue for quite a few years and he is on the Academy Committee. For anyone interested, I have 15 copies and I'll put them up on the table when I'm done.

Everybody on the panel so far has stressed that these are recommendations. But in Recommendation 13A the wording on the separation of accounts in Section 12 uses the word "requires". Could you clarify that?

MR. GARBER: All we are saying is that the effective operation requires it. It doesn't mean you have to have an effective operation.

MR. DICK MILLER: We can turn this around, and we wrestled with this and came to the conclusion that none of us could conceive of a situation where we would condone an actuary stating he complied with the Contribution Principle where he did not have a separation of accounts to demonstrate the emergence of earnings.

MR. DAVLIN: You don't feel that can be done in a general account with an asset share model?

MR. DICK MILLER: Okay, probably you could. If it were noted as an exception and then explained as to how you arrived at what you feel is appropriate.

MR. DAVLIN: I have a comment on the profit limitation. I don't see anything ethically wrong with a contract where we would distribute say 50% of the pre-dividend earnings to the policyholders. It might be an item of disclosure, but if they're aware of it, I don't see why we shouldn't be able to market that product.

MR. GARBER: You're right. If you illustrate 50% at the beginning and you carry through with that there is no problem. The difficulty is if you illustrate on the assumption that you're going to take 10%, and then you start taking 50% and that causes you to cut into the actual dividends you're paying. That is what we were trying to get at, and not that you couldn't illustrate 50%. We were concerned with substantial changes in practice. The example you gave is precisely what caused us not to use any numerical standards.

MR. DAVLIN: That does describe our practice. We view the illustrative dividends as implied in the contract. Margins are a certain percentage that varies by plan and age, and we try to stick with that. Another comment has to do with the Continuity Principle on a product where you're trying to follow pure expectations as opposed to any distribution of prior losses. I can see where my expectations could change even with no change in experience. For example, my initial expectation may be that the trend is going to change, but it may not develop.

MR. GARBER: That would be an interpretation. It is really the expectation of anticipated experience that is the change.

MR. DAVLIN: Why is it important to have the Continuity Principle?

MR. GARBER: It is the underlying principle of Recommendations 13B that if you are going to make a change it should be based on experience and not willy-nilly. And everything ties around that, and that's a change up or down. Although our lawyers are questioning whether it should be applied in a case where you are making a change favorable to policyholders.

MR. DAVLIN: The Continuity Principle is presented as generally accepted practice and I think you just invented the practice. I'm not aware that the Continuity Principle is generally accepted practice.

MR. GARBER: Of course it's not. This is a new area. We were trying to define what generally accepted practice should be. Now if it becomes accepted, then it is generally accepted practice (laughter).

MR. WALTER MILLER: No kidding, you have to start somewhere. I hope everybody would agree that we can't wait 15 years for a whole body of emerging practices to develop in this area before we make the attempt. Now that vacuum I was talking about will have been filled long before that. We can't afford to wait. Events are forcing our hand.

MR. DICK MILLER: This is a draft report. It has not cleared the Board, and it won't clear the Board if we don't have rather overwhelming support of the members of the Society.

MR. GARBER: Do you believe there should be a principle that would govern our behavior?

MR. DAVLIN: No. I think it is too early in the game. I don't think it's clearly thought out in a lot of companies' minds and I think we need more literature and more thought on the subject. I think it is premature . I see that we can't wait 15 years. We've waited quite a long time on the dividend side. Over a long period of time we developed the literature, and now we're beginning to certify that. I think we have to take the same slow and easy approach on the indeterminate premium contract.

MR. WALTER MILLER: The indeterminate premium contract is a perfect example, because if we want any professional presence in these areas at all, we don't have the luxury of waiting. It's funny that you talk about the traditional indeterminate premium policy - the simple one - and not the evolving variations. But as was commented on before, that policy, or that type of policy, is now subject to guidelines in a number of states, not all of which are uniform, and at least some of which can be challenged from the standpoint of whether they really reflect sound actuarial principles or not. I can't document for you what I am going to say, but I feel it quite strongly. I think there is substantial agreement here that if we as a profession just sit back then regulators, or consumers, or the Feds, or somebody will be in there faster than we think. Then anybody who is worried about enhancing the value of an FSA and maintaining our professional identity as actuaries, and who feels we have an expertise that is worth things to people can forget about it. It's just another way of chipping away if we let things like this happen.

UNIDENTIFIED SPEAKER: I didn't notice that reinsurance treaties or terms came under experience factors anywhere in the document and I thought that might be very important to include.

MR. ROBIN LECKIE: I couldn't find anything in 13A, although there may be, as to what you do with transfers from the non-par account to the par account, and whether we're supposed to treat those as dividends to be distributed according to the contribution method or whether we can use our own judgment as to what we do.

MR. GARBER: I guess you are concerned with the flow out of the non par account rather than the flow in. Returns from the participating account to the non-par account are within the scope of what we're talking about here. But we didn't deal with the reverse flow. We do have a comment dealing with a return on the investment in the participating business.

MR. GARBER: This is the V.P. in charge of the Committee.

MR. RICHARD ROBERTSON: I'm not speaking as a member of the Board of Governors at this point. I've been concerned over the application of principles to indeterminate premium products and other products with non-guaranteed elements. The more I hear the more concerned I get. As we know, there is a great deal of product innovation out there now, probably more innovation than most of us would like. But in terms of public

interest, I am convinced that it's healthy. Even among the products that now exist, there is no generally accepted practice as to how these non-guaranteed elements are determined or changed. In fact, to the extent to which there is some kind of pattern followed, I'm pretty sure it's outside the scope of the principles that are in this exposure draft. I think Dick Miller's comments are evidence of that, as are comments from many of the other people here.

I think it is completely improper to put forth concepts as generally accepted or to suggest in any way that they are preferred, as I believe this exposure draft does, when they are not in fact, in the common sense, generally accepted.

Probably the best advice I could give the Committee is to do just what you're doing. Get the material out, present it in forums such as this. But more aggressively try to seek out the problems with it. We are all very busy, I think actuaries involved in product design are probably busier than most these days, and I'm afraid it won't get the attention it really needs. I think when they do they can contribute. I think that there is room for considerable improvement. I would suggest not putting forth principles as standards against which practices are to be compared, but rather simply ask for disclosure as to what is done. That way there is no negative connotation if someone says we are not following the recommended procedure.

MR. WALTER MILLER: Would you propose that as a solution for all time in this area?

MR. ROBERTSON: Of course not. Practices will evolve. Allow them to.

MR. GARBER: Well, they are allowed anyway. We have an information problem. Unless people write papers on these subjects, it is very hard to get information as to what the actual practices are. The whole Society was astonished at the diversity of practice in the mutual company dividend area; and the stock company dividend area had a standard deviation at least three to ten times as large as that. It's difficult to get information and to know what the practices are and then decide what the practices should be.

MR. ROBERTSON: Sure that's why I'm not unhappy with the process you're going through. I think getting out like this and getting comments is probably the best way to get information as to what practices are.

MR. WALTER MILLER: I'll venture a guess that if the disclosure route, which is certainly worth some consideration, is followed, the next thing that is going to happen, and quicker than most of us would wish, is that organizations or individuals or bodies other than professional actuaries are going to start looking at these emerging disclosures and they're going to start setting up regulations and saying we can do this, we can't do that, this is good, this is no good. Some of those judgments are going to be informed, but some of those judgments are going to be considerably less informed than if they had been made by the professional actuarial bodies - the Society, the Academy and the CIA. In general, I certainly agree that it's possible to claim a kind of catch twenty-two situation attached to a generally accepted principle that deals with a problem situation that has been in effect for such a short time. I really hope that most Society

members, having considered that point, will also consider the alternatives and at least decide that the route of pushing forward with these Recommendations is going to be - I'd like to say - better. But, the alternatives are worse. Somebody else is going to do things that we should be doing.

MR. GARBER: The term "generally accepted" is clearly an overstatement. It may be well to use a term which implies that it is an interim standard to be reviewed from time to time, and put a sunset provision on it. But at least we should set something out against which we can measure. Then if that doesn't prove to be right over time, you have a chance to move to something else.

MR. DICK MILLER: I'd like to quote once again from Bill White's letter. "D.S. Rudd, in his addendum to the report suggests that your work would seem more appropriate as guidance to regulators and the industry than for the profession. This may apply for Canada, but I would strongly disagree with respect to the United States. No amount of bravado or puffery can disguise the fact that life insurance regulation on this side of the border, and outside of New York, is declining rapidly. Fortunately actuaries at the same time are asserting their professionalism, independence, and recognition of obligations to publics beyond their immediate employers. There is no practical way that the principles in your report or any comparable set of rules, can be enforced by government agencies. They must be impressed on actuaries as statements of conscience and ethical conduct and their sincere adoption by actuaries will go far toward establishing us truly as a profession."

If that paragraph had been written seven years ago it would have formed a charge for our Committee, an extremely high minded charge. It may be beyond our practical ability to achieve, but I am going to wave the Committee's flag here. This is the highest praise that I think we've gotten.

MR. TOZER: After hearing some of the comments here today I'd like John Harding to comment on implementation. What is the normal procedure from the Academy standpoint if a exposure draft like this were adopted? I would think that ordinarily the Academy would operate in the realm of some of the issues we talked about earlier - is it going to grandfather certain old business or is it going to be applying the Recommendation to all business in this type of thing, or is the Academy possibly giving any consideration, so to speak, to rewriting the principles? I guess I'm really thinking about what freedom of movement the Academy would usually feel they had when something like this came down the pike from the Society. What is your realm of movement and what is the Society's area?

MR. HARDING: Can I start by saying I wish I knew. In general, we have been pretty loose back and forth as to when the Society stops and when the Academy starts. With respect to this specific issue, I think it's quite clear that the Society Committee has developed a statement of principle that, in an ideal world, you would never have had anything but participating policies that were called participating. That's not the case, and I think that both the Society Committee and the Academy Committee would agree that some means of transition should be found. Harry, do you want to comment?

MR. GARBER: When the current recommendations were at the stage we are at now with the new recommendations, the Academy Committee began to look at them, work with them, and our Committee worked jointly with the Academy Committee to the point of changing the principles to some degree from our original proposal. So it'll be a joint effort on principles, but what the Academy Committee will produce will go beyond principles and get into practicality. I hope the statement of principles will essentially be the same between the two documents. But the Academy Committee's implementation role will carry them beyond the principle area into how to introduce recommendations in a practical fashion in a difficult world.

MR. LECKIE: I just didn't want Dick's remark to be left unchallenged in terms of Canadian regulation. In Canadian law, there is a definition of par and non-par and there is a restriction on how much from the par line can go to the non-par line. It's a restrictive one operating in the interest of policyholders. Other than that, I don't know anything I would suggest. That statement applied for the determination of the valuation laws that are in effect in Canada and we don't have non-forfeiture laws, so that the situation you suggested for dividends in fact applies in valuation and non-forfeiture, and I would commend that to the United States.

MR. GARBER: I might mention that one of the areas I would think the Academy Committee would look closely at is what is a report. Obviously, if you're changing rates monthly, you're not going to prepare 20 page reports every time. So the question of what constitutes an actuarial report in that kind of fluid circumstance is something that the Academy has to look at in addition to all its other problems.

MR. TOM LEARY: I'd like to read a letter addressed to the Committee. A number of these comments have been made in a similar vein but I would like to have this on this record.

The exposure draft of your Committee states on page 7 that "We started with the conviction that there should be an appropriate relationship between non-guaranteed charges and benefits and the underlying experience of the company. This is the basis of the policy dividend recommendations and we believe it should apply, as well, to these new coverages." The first approach considered on page 7 clearly would result in a recommendation calling for an appropriate relationship between non-guaranteed charges and benefits and the underlying experience of the company. I am concerned, however, that the second approach (the Continuity Principle) might not result in the appropriate relationship being maintained.

Under the Continuity Principle, it is not required that charges or benefits must be changed if the underlying experience changes. Rather, it is only required that <u>if</u> charges or benefits are changed, the changes must be based on changes in the underlying experience.

If a company chooses not to change the charges or benefits even though the underlying experience has changed, then there will not be an "appropriate relationship between non-guaranteed charges and benefits and the underlying experience of the company".

Since the Continuity Principle does not seem to satisfy the criteria established by the Committee, I would urge that you reconsider the implications of the Continuity Principle. Without some assurance that the company will change the charges or benefits when the underlying experience changes, the buyer of a non-guaranteed policy or a policy involving excess interest credits or other non-guaranteed charges or benefits will not be in a similar position to the purchaser of a traditional participating policy issued by a mutual company.

MR. WALTER MILLER: For the record, maybe this is an appropriate point for me to comment on a discussion which was prepared by Frank J. Albert of our company. I don't have time to read the whole thing. It will be in the Record. Frank's basic motivation was similar to some of the things that Tom said. He didn't believe that the Continuity Principle as currently proposed would adequately deal with bait and switch tactics. He ended up making three recommendations which were: (1) in the initial determination of non-guaranteed charges or benefits, that charges be reasonable for the benefit provided, (2) in subsequent redeterminations, that charges be reasonable for the benefits then provided, and (3) here is a pretty direct correspondence with Tom Leary's suggestion - significant changes in experience should require a change in non-guaranteed charges or benefits subject to practical constraints. My personal opinion is that, looking at the world that is around us already, that's too darn restrictive because you're trying to force everything into the traditional par mold. I don't think it will work and I don't think it's necessary in order to say that sound actuarial principles are being followed. I would hope the final determination is that the Continuity Principle does not need to be tightened to the extent proposed.

MR. GARBER: As stated in the report, there are members of the Committee who feel just as you do, Tom, so that was a matter of considerable discussion.

MR. RAMSEY: I want to be clear on your intent. As I hear the discussion, you really mean for the definition of the Continuity Principle to read "should be based on changes in the expected underlying experience" - is that correct?

MR. GARBER: Yes, the experience on which the actual premiums or benefits are based, which is the anticipated experience.

MR. RAMSEY: From a wording standpoint that is very critical.

MR. GARBER: Yes, we didn't want to get too precise. Ordinarily, it will be anticipated experience, but if someone happened to be using current experience as anticipated experience, we certainly didn't want to prevent them from doing that. If you want to assume what is happening today will continue into the future - that's a projection method. Our intent is for the expected underlying experience to be the experience on which the charges or benefits are based.

MR. KEN CLARK: I previously sent you lengthy comments which I hoped would be part of the Record. The general tone of what I said is that it seems premature to be stating that the Continuity Principle is generally accepted because it's really not, obviously not, accepted. On page 7 of

the report it says that one of the principal objectives was to avoid diversity. It seems to me that until we give diversity a chance to be practiced, to see what the actual practices will be, we shouldn't be setting in stone, in such concrete detail, what those practices are.

MR. GARBER: Our language is to avoid undesirable diversity, not just diversity.

MR. CLARK: But how do we know in advance what is desirable and what is not?

MR. DICK MILLER: Ken, I have great sympathy for your position, but I think the marketplace will require of us that we arrive at some sort of workable definition that can be applied to sales illustration costs.

MR. CLARK: The controversial issue is when are the guidelines needed, and can we put them in stone today or do we need to wait? There seems to be a lack of allowance for the role that competition plays in setting rates, or the role for consistency purposes the other rates that the company may have for similar products. For example, ART products may be priced trying to conserve the business rather than underlying experience.

I mentioned interest rates on deferred annuities where the prime concern was conserving the assets. You would hope to return to actuarial principles some day. I don't know how to express such overriding considerations in this kind of guidelines. They are not really actuarial, but they are an important part, perhaps the most important part, of rate setting.

MR. GARBER: When you write a report, that is precisely what you say. If there are overriding considerations, then you say you haven't followed the guidelines for those reasons.

MR. REISKYTL: I 'd like some clarification from Dick Robertson, Ken Clark or someone. We didn't use the term "projected experience factors" and you can even drop the word "experience", but it's whatever you imagine the future may be. The fundamental question here is whether you should have any comparability between old and new business. That's why page 7 is being quoted so often. Underneath it all, and really that was the problem in the dividend area, was that the buyer didn't know what was going on and we had all kinds of things in the marketplace. I hear you, Ken, and maybe Dick saying well maybe we ought to have the buyer in a state of confusion again. That may be a little harsh, but you're saying there are no generally accepted practices, there are no generally accepted principles. Maybe I'm waving the same flag that Walt was earlier, but I believe the profession has to take some views and establish some standards, whatever they may be. If you have a better standard, tell us what it is. But how is your buyer, how is any buyer of any of today's products to know what he is getting? We use terms like universal life, which seems to imply that you can own that policy for a long time. Are prospects being told when the intent of the actuary and of management is to price future products totally differently from the ones being sold today? If they're being told, I don't really care because if you're told in advance, that's fine. But if products are sold with the understanding that there is going

to be some continuity and the actuary prices the next product a different way, then there seems to be a fundamental problem. Are we creating the dividend situation all over again, and can we afford to do that as a profession and as people competing in the marketplace?

MR. ROBERTSON: I think the solution is far from clear, and it's not clear in my mind whether the degree of confusion this might be creating in the market is necessarily good or bad. That is, the public has an interest in the diversity of products that are available to it. The public also has an interest in the understandability of the products and these are, to some extent, competing interests. I would not presume one predominates at any time. I am also concerned that some of the speakers, while not directly doing so, may be hinting at bad faith on the part of managements that are offering some of these products.

I think the best approach for the long-term interest of the public, the industry, and the profession may be to accept that we're going to have some things that aren't quite neat for awhile, and that with things changing a bit there will unfortunately be some abuses, but that might be the price that has to be paid.

MR. WALTER MILLER: I have to say again that I hope we can reach a consensus that will have a different result than that, because I really fear for the viability of the actuarial profession as something that's worth anything. Our professional discipline and training and creditability with our management and our ability to influence them should be utilized in ways that will in the long run be good for the public, for the industry, and for ourselves. I just fear that we would seriously be hurt if we couldn't find a way to move forward. I am certainly willing to agree that if we had to do it all over again, we shouldn't have attempted, even in a draft, to call the Continuity Principle generally accepted. I hope we can agree that that doesn't mean we shouldn't move forward at all at this time.

MR. GARBER: If you issue any new contract or any new coverage, you or the management of the company have some intent as to what is intended. Otherwise you wouldn't be issuing that particular contract. I think the question is, does the Continuity Principle stand up as a statement of what you intend to do? If it doesn't, then we need a new principle. I'd appreciate getting any comments, now or in writing, as to what other statement would describe what you intend to do in the future as you issue a new form of contract. And maybe there is a better principle that is more encompassing. But the Continuity Principle is the best one we could develop and we thought it expressed intent in an appropriate fashion. But it may not have. It may be too restrictive.

MR. CORBETT: I want to pick up on a concern that I expressed about the Recommendations emphasizing principles more than reports to employers. I'm wondering if we shouldn't look again to see if it could be recast in this way. Talk about the things that should be covered in a report, for instance, whether or not past losses are to be taken into account, whether or not a company's policy is to be to change the premium if future experience changes. You've been open on it, but surely the company must have some policy. Give some format to the type of questions that have to be answered here so that there would be some comparability between companies out of which principles can emerge. Principles can be

identified if we have to address the underlying questions. Could your draft express the things that must be answered in order to develop one of these policies or to have an actuarial philosophy? I don't think anybody is denying that there are actuarial philosophies or standards involved here, simply that we don't know which are the right ones.

Going through my mind was an analogy with purchase accounting. It's not exact because when we get into GAAP we were tied into the accountants and we're not our own masters. We are to a greater extent here. Going back some eight or nine years after the audit guide had been put together, we were into purchase accounting for life insurance companies. I'm not sure to this day whether a generally accepted principle has emerged for how we should account, under GAAP, for the purchase of life insurance companies. But we've seen diversity of approaches. We've seen papers on this and I think we're flowing towards one.

Many flowers can bloom in this area, but if we have some context within which they can bloom, it will be easier for us to identify the principles eventually.

MR. GARBER: Jim, do you want to have the last word?

MR. REISKYTL: I've heard a lot today and it's all helpful. Walt started out by asking you to give us concrete things. Some of you are not ready to accept the Continuity Principle as generally accepted practice. Is there anything else that is offensive? Do you find that the Recommendations will, in any way, limit what you are doing today? I'd like to hear answers to those types of questions rather than about some broad I-don't-want-to-be-constrained-at-all principle or that we're not ready to move. I view this as a very modest proposal, but maybe it isn't. Hopefully you'll send us additional comments. Tell us, in particular cases, what is troubling you and be specific about a better way of doing this, because we can't deal with generalities.

End of open forum. Letters and papers that the Committee has received *from members, before or after the meeting, appear on the following pages* as part of the record of the forum.

MR. KENNETH CLARK (letter): Draft Recommendation 13A provides a reasonable guide for determining dividends for participating policies issued by either mutual or stock companies. The principles are consistent with my knowledge of current practices of large writers of participating business. These recommendations may or may not allow the necessary flexibility for those companies to deal with the product needs of the rapidly changing life insurance business. Is there sufficient flexibility in 13A to not restrict those companies in the future?

Draft Recommendation 13B develops very similar principles and practices for the non-guaranteed elements of non-par policies. The Committee's draft is consistent with this objective. But is that a sound objective?

The Committee's decision to develop similar guidelines for non-guaranteed elements of non-par policies was based on several arguments. Are those arguments valid?

The Committee concluded that the buyer of a policy with non-guaranteed elements should be in the same position as the purchaser of a par policy. That would have sounded reasonable five years ago but ignores the type of products that are now popular. Today's important products are term and excess interest products. The buyers of these products (or their agents) periodically make a decision whether to keep their current policy or replace it with a new one. The Committee fails to recognize that the most important factor in setting the level of renewal charges and excess interest rates will be competition. The actuary will be looking at the relative profitability of keeping current business on the books versus acquiring new business. The Committee has not given sufficient recognition to fundamental differences between traditional par policies and the term and excess interest policies being sold today.

A second conclusion was that guidelines are needed to prevent the development of diverse practices. In other words conformity is, by definition, desirable. Are we sufficiently certain what tomorrow's products will look like to adopt principles and practices with the objective of limiting diversity? The Committee did acknowledge this problem and said they tried to leave room for new concepts and products. But they have taken the continuity principle and applied it across the board with recommendations for non-par in nearly every case parallel to corresponding recommendations for participating policies. No allowance is made for the competitive and practical considerations that may lead companies to depart from a purely theoretical application of the continuity principle. I admit that some protection against arbitrary and unfair treatment of policyholders may be needed, but it is not clear to me how that should be accomplished.

Recommendation 15 under 13B says a company should not attempt to recover past losses or distribute past earnings in recalculating benefits or charges. This may be theoretically sound, but doesn't take into account the overriding interests of companies trying to earn a reasonable profit, retain in-force business or possibly even survive.

Excess interest rates today commonly reflect returns on short-term investments. Obviously, earnings on those investments will fluctuate widely. Recommendation 17 would require the actuary to disclose that there is a substantial probability that the benefit can't be maintained beyond the current guarantee period. Does management really need to be told what should be obvious?

Recommendation 18 states that sufficient accounting and actuarial records must be maintained to assure that experience can be measured in order to apply the continuity principle and related tests. This will be viewed by most small and many large companies as an unnecessary expense burden. Each company should decide the degree of detail it needs to run its business. This recommendation could be used by regulators or auditors as a ground for requiring additional record keeping.

The 18 recommendations under 13B are consistent with the Committee's overall conclusions. I've referred to specific recommendations only to illustrate why 13B won't work rather than to suggest rewording those recommendations. The basic conclusions are at odds with the marketplace. One gets the impression that the draftees of 13B have no or little experience pricing non-par products.

It is premature to draft detailed guidelines based on a strict application of the continuity principle in light of the rapid evolution in products. More than fine tuning is needed before 13B should be approved.

MR. RICHARD COOMBS (letter): This letter describes my views of this set of recommendations as an actuary of a small stock life insurance company.

In general, I believe the draft to be very well written. The particular comments I have are:

1. We sell a non-participating flexible premium deferred annuity. The current interest rate is determined by the Board of Directors at the beginning of each calendar quarter. The actual rate declared is determined by the President, who handles all investment affairs of the Company. The most involved in the process that I have been is to verbally predict whether interest rates in the market will rise, fall, or be steady; this kind of prediction, of course, requires no particular actuarial skill. Am I in violation of Recommendation 1? My feeling is that I am not violating it: I am acting in the capacity of a prophet or guru and not as an actuary.

2. Recommendation 11 says "indirect costs should be allocated". There are methods in which the indirect costs are not allocated to policies or groups of policies, but rather policy results are accumulated (without any indirect costs) and the projected entire company results (with indirect costs) are examined to make sure that goals are met. Are these methods to be "outlawed" for indeterminate premium policies?

3. Recommendation 14 deals with profit and risk provisions in the premiums. If in a premium/benefit redetermination the provision for profit and risk is "changed in overall level or structure", this is to be disclosed in the actuary's written report. If the expected profit in years two through ten under the original premiums and experience assumptions is equal to 20% of expected premiums in those years, and

if the expected profit in the same years under revised premiums and assumptions is also 20% of expected premiums, is it necessary to disclose that expected profit in dollars per $1000 of insurance changed considerably?

4. I agree that past gains and losses under these types of policies should not be distributed to policyholders or recovered from them through appropriate changes in premiums or benefits.

5. Recommendations 16 and 17 require that tests be conducted to determine the effects of adverse deviations on premiums or benefits in order to determine whether there is a "substantial probability" that the new scales could not be maintained. What does "substantial probability" mean? Is 20% substantial enough to be disclosed? I prefer the approach taken in Recommendation 20 of the Draft Recommendations 13A, where the "substantial probability" required is that the scale could be maintained under currently expected experience.

Once again, the Committee has done a lot of good work in developing the draft recommendations. They just need a little fine-tuning.

MR. D. C. TOWNSEND (letter): Comment has been requested from Society members on the Exposure Draft dealing with dividends and indeterminate premium policy re-pricing.

I agree with Mr. Rudd's comments. The recommendations are desirable, but are impractical in a stock company without separation of accounts and legislated limitations on the shareholder take.

I speak from the vantage-point of a company registered under provincial law rather than federal law in Canada. Participating policy directors are not required, separation of accounts is required, and the shareholders' take has been limited by Company by-law rather than by the provincial Act (although I have reason to believe that the Act would be changed if any provincial company did not comply voluntarily with federal legal limitations).

The lack of policyholder directors does not appear to cause any conflict with the recommendations, but the other two requirements are essential to avoid conflict. I believe that legal separation of accounts and limitation of shareholder take should be recommended to all state legislatures, and the recommendations should specifically apply only in companies where these limitations apply.

MR. WILLIAM WHITE (letter): The Committee on Theory of Dividends, etc. deserves the unqualified thanks of our profession, the life insurance industry, and insurance regulators for its outstanding report on dividends and other non-guaranteed elements. This letter will offer comments from an individual who has been close to the activities of your committee and its predecessor since their inception. If any of my comments are perceived to be critical, then I have failed to communicate.

My remarks are offered as a regulatory actuary and do not necessarily reflect the thinking of the New Jersey Insurance Department. The sequence of comments follows the presentation of the report and draft recommendations. I will conclude by assigning relative personal priorities to the issues.

One of the most controversial statements in the report undoubtedly appears at the bottom of page 3: "The Committee concluded that there were two key factors that should characterize the participating business of stock companies . . . (2) there should be a reasonable and consistent limitation on the amounts of earnings on participating business that may be diverted to the benefit of shareholders." I disagree with this conclusion. The implication is that profit control is appropriate for the actuarial profession and regulators. Traditionally both disciplines have-justifiably-avoided such control. Our insurance system on this continent is predicated on profits being controlled by the marketplace.

To the extent that the marketplace is imperfect, the approach should be to improve the marketplace rather than to impose external controls. This (perfecting the marketplace) was the original regulatory impetus behind the first dividend philosophy committee. The responses of both committees do, in my view, go so far toward marketplace improvement that the sort of artificial measures implied by the quoted conclusion should be postponed, if not discarded.

I suspect I have often been considered a proponent of life insurance premium rate and profit regulation. In my writings, I have always tried to distinguish between "rate regulation" and "rate change regulation". The distinction is that a company should be permitted to target any non-hazardous (that is, positive) profit objective in its initial premium and illustrative dividend determinations. A competitive and well-informed marketplace will react to those determinations and reward companies that have attractive pricing and efficient operations. An abuse exists if a company competes on the basis of low prices, and related profit expectations, that it has no sincere intention of maintaining. Thus "rate change regulation" is a control mechanism to require reconciliation of emerging prices and profits with those which underlay the original sale of a policy. This, as I see it, is the heart of your "Continuity Principle."

It is surprising (on page 4 of the report) that your list of alternative approaches to the treatment of dividends for stock companies whose practices do not conform to fundamental principles was limited to three. The Committee seems to have concluded that companies should be entitled to classify their business as "participating' and their distributions as "dividends" even if there is no intention to adjust the illustrated figures to reflect actual emerging experience. The industry has come in for a large amount of undeserved criticism for using the term "dividend" in its classical gerundive sense. (Critics of participating insurance insist on equating "dividends" to "interest" or "profits".) For our profession to condone the use of "dividends" to refer to non-guaranteed coupon or endowment benefits might lend credence to those criticisms. My fourth (preferred) alternative approach would be: "Design the Recommendations to apply to all companies, but limit the use of the words participating and dividends to instances where fundamental participating principles can be met; in all other instances the company should be prohibited from using those or like terms and should be fully subject to the Recommendations for Policies Containing Non-guaranteed Charges and/or Benefits."

On page 9 of the report (last paragraph, carried over to page 10) the Committee seems to have had unusual difficulty agreeing on the treatment of past experience losses. If a company routinely anticipates increasing

its profit or risk factor in order to recover past experience losses for a block of business, then that business is participating, and the company should similarly reduce those factors in order to return more favorable experience than originally expected. Comments concerning page 8B describe solvency-threatening situations where a company must be permitted to increase risk and profit factors. In other than those situations, it would seem clearly inappropriate for the non-participating business of a stock company to be permitted to increase rates so as to recoup prior losses.

On pages 5A and 6A, in the statement of Investment Income Factors, the committee was understandably reluctant to make unnecessary changes in the wording that has been carefully reviewed and ultimately accepted in the present Recommendations. Direct recognition of policy loans (the four-factor dividend approach) and segmentation of assets for dividend classes (the Attwood-Ohman paper) are new since the original report and are close to being "generally accepted actuarial principles". I can interpret the existing Recommendations as embracing these concepts, but I wonder if it would not be wise to spell them out so as to avoid uncertainty.

In paragraph 1.2 on page 1B the statement is made that the "Recommendations . . . do not apply to charges or benefits that follow directly . . . a defined index". This statement seems straight-forward but might be subject to misinterpretation. For example, the Recommendations would apply to mortality and expense factors in universal life or indeterminate premium policies where the interest credited was a predetermined function of external interest rates. Similarly, the Recommendations would apply to an interest-indexed policy if the company routinely paid or illustrated interest in excess of the index. My concern may be trivial, but a statement to clarify the "defined index" exclusion could avoid misunderstanding.

The Continuity Principle first appears on page 2B. The argument was undoubtedly made, within the Committee, that it is unfairly discriminatory to apply this principle primarily to stock companies and non-participating business. Was consideration given to incorporating the principle into recommendations 13A so as to apply to the progression from illustrated dividends to paid dividends and to the year-to-year changes in dividend scales for conventional participating business? There are no conceptual disadvantages I can see in such an extension, and the application of the Continuity Principle to illustrative dividends would, in my opinion, well serve the insurance-buying public. A discussion of this would be appreciated.

On page 3B, Policy Classes are defined, among other things, in terms of time periods. The time period is identified as extending from "a few days" to "several years". I can appreciate the "few days" class as necessary for indexed-interest plans, although the exclusion discussed earlier seems to make this unnecessary. What bothers me is that the report might be used to justify a proliferation of small, closed blocks of business. Experience with health insurance rate changes indicates misunderstandings and public relations problems when experience starts to deteriorate in a small, closed block of business.

The thrust of the Recommendations should be to discourage, to the greatest possible extent, large numbers of "policy classes". This is desirable in order to provide stability and credibility to "class" experience and to permit the kinds of true spreading-of-risk on which our business is predicated. Creation of new "policy classes" should not depend on ratebook republication or routine changes in interest or mortality assumptions--these can be accommodated within a class as time-dependent variables. The critical factor in policy class determination should be the insurer's anticipated treatment from issue of the policyholders in that class, particularly in terms of rating assumptions and profit objectives. Arbitrary reclassification after issue would appear to be a violation of the "Continuity Principle".

The last sentence of section 4.2 seems somewhat incongruous for life insurance policies--occurrence of a claim will normally result in the policy's being assigned to a new class. Preferable, to my mind, would be a statement patterned after the Trade Practices prohibition against "unfair discrimination between individuals of the same class and equal expectation of life," with the class and expectation measured as of policy issue. The industry is presently in the midst of de facto reclassification of existing policyholders, into insurable and uninsurable factions, by means of widespread replacements and re-entry term products. I feel that this is extremely dangerous (from both a solvency and equity standpoint), and I would be disappointed if our Recommendations encouraged it further.

Section 12.1 on page 7B embodies a concept that is relatively easy to state but very difficult to enforce--that "provision for profit and risk should not be increased . . . unless there is a clear increase in risk". You will probably receive more objections to this than to any other portion of the Recommendations, if our experience with a similar policy-forms-approval guideline in New Jersey is any indication. Legitimate questions arise if the original rates were based on innocent actuarial error or bad managerial judgment. You are also skirting the "proprietary information and trade secret" areas and have a seeming inconsistency versus the freedom to change surplus-increment factors given mutual companies by Recommendations 13A. I hope that the sense of this paragraph and of Recommendation 14 can survive, but I am not optimistic.

As I mentioned in my discussion of page 9, the statement on recouping prior losses, while proper, may be unduly restrictive. Section 13.1 on page 8B states that "a company should not seek to recover past losses in redetermining charges and benefits". This makes sense when we mean that a company should not increase risk and profit elements in order to realize expected profits (or erase unanticipated losses) that have failed to materialize. Clearly, however, increases in profit and risk elements must be permitted when the alternative is insurer insolvency. At this point, the actuary's responsibilities are to ensure (i) that the increases are applied equitably to all classes of business and (ii) that the amount of increase is commensurate with the amount necessary to restore or assure solvency.

Section 13.4 on page 8B goes part way toward the problem of unrealistic cost projections in the sale of policies with non-guaranteed elements. However, I think you have over-applied the Committee's close vote (page 8) not to require changes in charges and benefits as underlying experience

changes. Recommendation 16 requires that the actuary conduct tests of the appropriateness of illustrative figures only at time of determination *or redetermination; that obligation should exist at any time.* I suspect that today (the first half of October, 1982) may be a perfect example of a period when companies are continuing unrealistically high interest illustrations on deferred annuities and universal life products in order to attract the large sums of money ready for investment as all-savers certificates mature and money market fund rates drop.

Along the same lines, there are other "abuses" of pricing theory that the report might have addressed. We in New Jersey have been concerned with the possibility of companies illustrating, and paying, interest rates on universal life that are higher than the company actually earns; the difference can be made up from unrealistically high mortality and expense charges (the assumption being that the prospect "shops" for interest rates that can be easily compared and ignores mortality and expense charges that are all but impossible to evaluate). Switching of costs and benefits among Policy Factors should be prohibited. The other abuse is the possibility of illustrating mortality charges on the basis of mortality assumptions that are early-duration-select at all attained ages; the company can later increase the charges for closed blocks of business (on the basis of emerging experience worse than anticipated) while continuing the select charges for new business.

It should be emphasized that these are "possibilities" rather than documented abuses and, as such, fall into the "please don't eat the daisies" category of guideline. As page 7 of the report states, it is desirable that the definition of principles and standards help to forestall undesirable developments--before they occur rather than after.

My opening paragraph expressed thanks to the Committee, and that was not the perfunctory compliment. You and the thirteen other members of the Committee show great courage and independence in your efforts. Harry Gershenson used to speak of what can be accomplished when you "stand on the shoulders of a giant". The original Dividend Philosophy Committee was such a giant. Many of us--myself certainly included--failed to appreciate the pioneering effort and enormous contributions of the original Committee. You have built forcefully and effectively on their efforts. I am especially grateful for your decision not to seek a consensus but rather to encourage dissent and to report that dissent to the Society membership.

D. S. Rudd, *in his addendum to the report, suggests that your "work would* seem more appropriate as guidance to regulators and the industry than for the profession . . ." This may apply for Canada, but I would strongly disagree with respect to the United States. No amount of bravado or puffery can disguise the fact that life insurance regulation, on this side of the border and outside of New York, is declining rapidly. Fortunately, actuaries, at the same time, are asserting their professionalism, independence, and recognition of obligations to publics beyond their immediate employers. There is no practicable way that the principles in your report, or any comparable set of "rules", can be enforced by government agencies. They must be impressed on actuaries as statements of conscience and ethical conduct, and their sincere adoption by actuaries will go far toward establishing us truly as a "profession".

I promised a prioritizing review of the comments. The importance of Continuity Principle is first, and its extension to conventional participating business seems inevitable. The suggestion to deny the words "dividends" and "participating" to policies that fail the requirements of Recommendations 13A would be second--the distinctions between par and nonpar are disappearing, but this does not justify permitting nonpar products to be called par. (There are obvious problems with minimum reserves and nonforfeiture values if some of the stock company "dividends" were treated as endowments or coupons, but I for one would vote to treat these policies as level-premium for valuation and cash value purposes, the same as we do universal life and non-guaranteed premium business.)

The only other "priority" comment has to do with rate and profit regulation. I feel that the Committee may have overreacted to perceived regulatory pressures when recommending limitations on the amounts of earnings on participating business that may be diverted to the benefit of shareholders. The Continuity Principle makes such limitations unnecessary, and they are inherently undesirable.

I will not be able to attend the Society meeting in Washington next week, but you are welcome to use this letter any way you see fit. I will be glad to elaborate on anything that is not clear.

MR. FRANK ALPERT (letter):

I. Draft recommendation 13B differs from 13A (Dividends) in two important respects:

   A. 13B calls for the "Continuity Principle" by which changes in pricing (or benefits) for a policy class are related to changes in experience for that class, instead of the "Contribution Principle" which "distributes .... surplus among policies in the same proportion (they) .... are considered to have contributed ...." and, in effect, sets the pricing of each class in relation to its share of the entire business. Note that the Continuity Principle does not apply to the initial pricing of a policy class although paragraph 1.4 makes 13B applicable to "both the determination of non-guaranteed charges and benefits on new business and .... the periodic redetermination of non-guaranteed charges and benefits on business in-force" with no way of implementation for initial pricing.

   B. 13B has no requirement that non-guaranteed pricing be changed when there is a change in experience.

   Apparently, these changes are made with the intent to minimize restrictive regulation and to permit greater flexibility on the part of the actuary, while still limiting the more blatant forms of unfairness or misrepresentation such as "bait-and-switch". The differences from 13A seem to be based on the grounds that the principle of equity inherent in recommendation 13A is not required for non-guaranteed pricing and is too stringent a constraint to carry forward where it is not specifically required by statute.

It is my opinion (a) that recommendation 13B as currently drafted contains inconsistencies or ambiguities which effectively negate any control, (b) that at some point the principle of equity among various policy classes is still important whether or not required by statute, and (c) that the draft recommendation 13B is contrary to the spirit of the regulations in New York and other states dealing with non-guaranteed premiums.

II. It appears on the surface that 13B is flexible enough to allow differences in pricing for market objectives (a fancy way of saying "loss leader"). However, a more complete analysis indicates that a paradox is reached which refutes the premise.

Assume, for example, that the initial assumptions in the absence of marketing objectives would establish a price of 100 but the actuary feels justified in using an initial price of 80. (The numbers should be interpreted as indices, not any specific value.) Assume further that subsequent experience indicates a price of 140 in the absence of marketing objectives. If the actuary decides to change the price, it is not clear whether the recommendation permits a change in price only to 112 (1.4 x 80), or to 140. If the former, the recommendations are condemming the policy class to be forever inadequately priced - a needless intrusion on management; if the latter, the recommendations leave the door wide open to "bait-and-switch" tactics.

III. Take another example, of a policy class initially priced at 75 when the initial assumption would establish a price of 100 in the absence of market objectives. Subsequent experience indicates a price of 80. Is the actuary justified in lowering the price to 60 (.8 x 75)? to 70? Depending on how the recommendations are read, neither or both of these may be justified. It does seem clear that he may not increase the price to 80, since it is difficult to say that an increase in price is "based on" a reduction in experience.

IV. The two examples given above are not mere samples of the universal law that it is possible to find a way around any set of rules, but arise from the structure of the rules themselves. The Continuity Principle as stated has two logical defects illustrated by the examples:

1) the Principle assumes (but does not require) that initial conditions are appropriate, and
2) by relating change in pricing to change in conditions, there is no appropriate level toward which successive repricings will move.

In short, there is no self-correcting mechanism. These defects would be eliminated if the initial pricing were required to be reasonable in relation to the benefits provided and each subsequent change in benefits or pricing were also subject to the same requirement.

V. The principle of equity embodied in 13A has roots both in (a) the nature of life insurance as a long-term, complex product. Once a customer has made a purchase, he cannot easily change if he then

finds he is being treated unfairly -- so his interests are protected by prescribing "fair" treatment for all; and (b) the competitive forces which promote consistency across complex pricing arrangements. Both of these factors are present in policies with indeterminate charges (or benefits), and one would, therefore, expect equity to be an important consideration on these policies.

VI. The New York Insurance Department has a four-page regulation dealing with non-guaranteed premium products. The Department requires that both original and revised rates be submitted to it in accordance with guidelines which are intended to "prevent unfairness and misunderstanding". Among other things these guidelines require that the actuarial statement certify that the proposed premium rates are reasonable, self-supporting, and do not unfairly discriminate between new issues and in-force. The proposed recommendations 13B fall short of the standard set in the New York State regulation. It is also worth noting that when non-guaranteed premium rates were first encountered - with respect to guaranteed renewable health insurance - a New York statute was passed requiring that "benefits be .... reasonable in relation to the premiums charged". Although this section applies only to Health Insurance, it can be argued that the same provisions would have been made applicable to life insurance if there had been non-guaranteed life insurance at that time.

VII. The definition of the Continuity Principle in paragraph 2.1 states that in a "broad sense it assures a degree of fair treatment required when charges or benefits are not guaranteed". It appears that the Continuity Principle is a necessary but by no means sufficient condition to assure fair treatment among different classes of business. Under the recommendations an actuary is within his rights to establish several different policy classes on varying levels of pricing. As experience develops differences among these classes may become much greater or much less than that perceived at the initial pricing. As long as the non-guaranteed rates are not changed there is no requirement that the policy classes have any degree of fair treatment compared with each other.

VIII. In summary, I believe the following changes are necessary to Recommendation 13B:

1) recommend that, in the initial determination of non-guaranteed charges or benefits, the charges are reasonable for the benefits provided,

2) recommend that, in subsequent redeterminations, the charges be reasonable for the benefits then provided, and

3) significant changes in experience should require a change in non-guaranteed charges or benefits, subject to the practical constraints outlined in paragraph 3.4.

MR. MARK HUG (letter): Enclosed please find an abstract written by Shane Chalke discussing a few of the major principles underlying dividend determination for mutual and stock companies. It also addresses some of the principles underlying the redetermination of other nonguaranteed element products.

SHANE CHALKE (abstract - see Mark Hug letter): In response to the Exposure Draft, a brief discussion of the differing responsibilities of stock and mutual insurers seems appropriate. These differences in principle underlie many of our disagreements with the procedures outlined in the Exposure Draft.

Insurance companies capitalized by shareholders and those capitalized by mutual policyholders have different origins, are responsible to different owners, and differ conceptually as well as philosophically. As such, the two different entities should be guided by differing principles. Both types of insurers, however, are bound by two obligations: one to the owners of the company and one to the policyholders.

To the owners, the company (management) must distribute profits in an equitable fashion. This distribution amongst the owners is usually in proportion to each owner's contribution toward realizing those profits. To the policyholders, the company must meet all contractual obligations.

When speaking of policyholders' rights, then, we notice that in a mutual company, policyholders have both the right to an equitable distribution of profits and a claim on all contractual obligations. In a stock company, policyholders earn only the latter: a claim on all contractual obligations. These obligations may be explicit or implicit.

Because the stock company policyholder has not purchased an ownership position in the company, he has no claims to equity beyond that promised by terms of the contract. As such, products can be marketed to different classes of policyholders with different expectations (and realizations) of profit or loss.

How does participating business sold by a stock company fit in? First, it is important to understand the difference between par and mutual. Participating business does not imply an ownership position; it simply guarantees participation in profits or losses. Mutual business is a special case of par: that where an ownership position exists (theoretically implying a claim to all profits). A contract which is participating (but not mutual) may contain any form of guarantee to fluctuate with profit and loss. For example, the contract may guarantee that 50% of all profits associated with that particular group of contracts will be distributed to the contract holders. On the other hand, a participating policyholder of a mutual company has the implicit right to all profits associated with the contract.

A significant problem arises when a participating contract in a stock company contains no clear provision delineating both the stockholders' and the policyholders' share of the ensuing profits. Here, a guide to professional ethics is in order. However, the participating policyholder in a stock company does not share the same rights as a mutual policyholder. As a policyholder (but not owner), he has rights only to contractual obligations, both overt and implied.

It might be argued that principles of dividend determination in place at issue form an implied contract to continue such practice. We feel that this would be a good underlying premise on which to base standards for professional ethics. It must be made clear however, that any overt contractual agreement contrary to any general dividend principles shall override such principles in the case of a stock life insurance policyholder.

Another type of contract available from stock insurance companies is not participating (nor mutual), yet contains non-guaranteed elements. Such contract holders enjoy neither the rights associated with an ownership position nor the right to any profits or losses. They are not entitled to the same rights of equity as are mutual policyholders. Neither are they entitled to share in the profits like a particpating policyholder.

However, any practice in place at time of issue may be viewed as an implied contract, and as such, an obligation of the company to continue such practice. A guide to procedures for the actuary might best be framed around this principle. Of course, any overt contractual agreement will override such principles.

As a final comment, readers of the Exposure Draft may infer that regulatory enforcement of the outlined principles is either desirable or necessary. We feel that this is inappropriate for such a draft. To maintain parity with the dividend recommendations for mutuals, we suggest that the recommendations be framed in terms of professional ethics and responsibilities, in a way so as to discourage over-regulation.

MR. CHAS. GALLOWAY (letter): There are three points on which I would like to comment.

(1) The Contribution Principle:

We, North American actuaries, have had instilled in us such reverence for this principle that it may seem heretical even to suggest that it may have some limitation. I believe that it is a sound principle and that a system of participating insurance which is designed so that it can be applied is more likely to be equitable and adaptable to changing circumstances than otherwise. Nevertheless, there are situations where there is some kind of agreement between the issuing insurance company and the policyholders, either express or implied, which limits the right of the actuary to apply the contribution principle fully. An example is the "uniform reversionary bonus" system employed in Great Britain, where there is an "expectation at issue" that surplus will be distributed in the form of uniform reversionary bonuses. It seems to me that it is incumbent upon the actuary to distribute the surplus in that fashion.

You might argue (as did the C.I.A. Committee) that recommendation #2 provides the actuary with an opportunity to deviate from the contribution principle in such circumstances and state his reasons.

Nevertheless, I would feel more comfortable with the recommendations if there were specific recognition of the principle of "expectations at issue" by stating that the contribution principle should be followed where it is not at variance with such expectations.

Such a change would have practical application in at least one case that comes to mind. An actuary who determines dividends recognizing the individual utilization of the policy loan privilege is undoubtedly following the contribution principle and, as the recommendations are now phrased, appears to be under no onus to justify this practice. In my view, however, if the contract contains a maximum loan interest rate, then this dividend practice is in violation of the "expectation at issue", which is clearly that the election of a policy loan will not create any direct or indirect cost to the policyholder over and above the maximum rate stated. If the recommendation were stated in the form that I have suggested, the actuary would then be called upon to disclose and justify his deviation from the "expectation at issue".

(2) Continuity Principle:

It seems to me that it is easier to justify the classification of non-guaranteed cost policies as non-participating if the non-guaranteed element is set prospectively from time to time and the company experiences profits or losses relative to the assumptions during some period before the adjustable cost elements are altered. From this point of view, it would seem desirable if the continuity principle were expressed in terms like, "... the levels of non-guaranteed charges or benefits after issue should be based on assumptions which recognize changes in the underlying experience." This seems to me to remove the implication in the present recommendation that the process is necessarily retrospective.

(3) Rudd's minority view:

Rudd says, "Our work would seem more appropriate as guidance to regulators and the industry than for the profession but the recommendations and report do not bring this into focus." I think there is some truth in that comment. For your interest, I have enclosed a copy of a submission made by the CLHIA to the Federal Department of Insurance which deals with this issue. I have highlighted some comments on page 5 which bear directly on one of the issues that Rudd has raised, namely, that disclosure to the management of the company may not be sufficient to protect the policyholder. It seems to me that so-called participating insurance issued by stock companies, where there is no limitation on the distribution of surplus to the shareholders, is NOT really participating insurance and that it probably falls into the "non-guaranteed cost" area. My personal view is that companies should not be permitted to call it participating unless it is subject to some restriction on distribution of surplus to the shareholders and the same principles are applied to it as are applied to participating insurance in a mutual company. Since in Canada the Canadian and British Insurance Companies Act imposes such restrictions on insurance which is designated as participating, I have no practical experience with this problem.

MR. RICHARD KLING (letter): The following comments are based on my experience over the last 10+ years in dealing with non-participating annuities that credit interest on a current basis.

(1) It appears that these recommendations apply to the initial process of pricing products that have benefits or charges that are not permanently guaranteed, as well as the redetermination process. At the time the contract is issued, there are no non-guaranteed elements. Every charge or benefit is initially guaranteed for some period, even if the period is not explicitly specified. My point is that initial pricing of these products is really no different than pricing products with guaranteed benefits/charges. It seems that these recommendations should focus on the redetermination process, not the initial pricing process.

(2) The underlying basis for redetermining non-guaranteed benefits/charges is anticipated future experience. This needs to be clarified in these recommendations.

(3) Section 12, Profit and Risk Factors, concerns me for several reasons:

(a) It seems that the stockholders have certain rights, e.g., to require an increased return from the business. This recommendation would seem to put the actuary in a difficult position.

(b) What does "provision for profit and risk should not be increased..." mean? Surely a constant profit objective is not consistent for all business/economic scenarios.

(c) Practically speaking, this section's bark is much worse than its bite. As an example, I've considered increasing the spread on particular blocks of annuity business at certain points in time. After considering the impact of potentially higher terminations (including the risk of an increased asset/liability mismatch), I've concluded that the return on investment would not change materially. The marketplace does not really allow an arbitrary increase in profit levels.

I've concluded that the actuary's primary responsibility in the redetermination process is to ensure that the company is complying with its promises, i.e., its contractual obligations and its customer disclosures (sales material, etc.).

HOWARD J. BOLNICK (letter): As an actuary with a business interest in a small stock life insurance company I read draft recommendation 13B and the supporting commentary with particular interest. I feel that the draft recommendation as currently conceived requires me to go well beyond what I view as my professional responsibility in pricing matters and seriously infringes on my rights and obligations to business partners.

The basic cause of this problem is the Committee's use of the Continuity Principle. The Continuity Principle is a wholly understandable modification to the Contribution Principle. But, in using this Principle to describe the actuary's role in pricing matters, the Committee fails to properly recognize the significant difference between an actuary's role in

stock and mutual companies. Simply stated, an actuary working for a stock company advises a management which, in turn, represents the stockholders. A mutual company actuary advises a management which represents the policyholders. Obviously, the interests of the stockholders and policyholders are not the same. And, it is not the job of the actuary to make these differing interests coincide.

There are many areas of professional practice where there is no difference in the role of the actuary in stock and mutual companies. A good example is the actuary's role in complying with state statutory valuation and other legal requirements. Product pricing, though, is not one of the areas in which this consistency of responsibility can exist. In designing and pricing a product the stock company actuary is primarily responsible to the owners and the mutual company actuary is responsible to the policyholders.

The Contribution Principle mandated by the Committee in draft recommendation 13A works for mutual companies because both the actuary and management are responsible to the policyholders on pricing matters. The Continuity Principle used in draft recommendation 13B does not lend itself to a similar mandated approach because of the potential conflict in interests between policyholders and owners in stock companies. The strongest use that can reasonably be made of the Continuity Principle is as a guide to preferable pricing methodology. It cannot be used as a mandated principle.

The use of the Continuity Principle in draft recommendation 13B, then, needs to be revised. The Continuity Principle can be presented as a sound approach for the actuary to use to analyze initial and ongoing problems faced by a stock companies writing the type of business covered by the draft recommendation. It also is appropriate to require that any Actuarial Report describe deviations from the Continuity Principle and offer support, if any, for these deviations. It is not, though, appropriate for the draft recommendation to contain any requirement to support the use of the Continuity Principle in reaching pricing decisions (see paragraph 1.7) or to proscribe actions that are the responsibility of the company's management (see paragraph 12.1 and 13.1).

MR. THOMAS LEARY (letter): My previous comments to the Committee were mainly concerned with the fact that the criteria established by the Committee are not met by the Continuity Principle. In addition, there are basic concerns about the use of the Continuity Principle as defined in the Draft Exposure Report.

When a company (either stock or mutual) sells a policy or contract where the policyholder is at risk, then this should be clearly communicated to the policyholder. I believe this is well handled for participating policies which have been issued by mutual or stock companies. The policy and/or ledger statements indicate that the policy is participating. There are usually caveats to the effect that dividends are not guaranteed and may change in the future. With the advent of non-guaranteed policies or policies involving excess interest credits or other nonguaranteed charges or benefits, the policyholder is in a similar position with respect to these non-guaranteed elements as he would be with respect to dividends on a participating policy. One would expect then that the policy or related material should disclose the fact that certain factors can change and under what conditions they can change.

At the Society of Actuaries meeting in Washington, it was indicated that there should be adequate disclosure by companies selling these new types of policies, and that this would be sufficient in alerting the policyholder to the fact that the ultimate cost of the policy can change. If that is the case, then the report of the actuary to management should include a section as to whether or not the disclosure specifications are being followed as experience changes. For example, if it was indicated that 50% of any increased investment earnings will be distributed to the policyholders, then the report should specify whether or not that is indeed the fact.

If it is not clearly specified as to how the experience will be reflected to the policyholder, then the recommendation should require that the actuary indicate in his report whether or not the underlying experience of the company is being reflected in the charges or benefits under the nonguaranteed policies. If the disclosure has not indicated any specific circumstances for changes in the charges or benefits, then it would be reasonable that the policyholder would expect that the experience will be the underlying experience of the company. In this respect, I do not think that the Continuity Principle is strong enough, since it does not require that charges or benefits must be changed if the underlying experience changes. If the company chooses not to change the charges or benefits to reflect underlying experience, the actuary's report should clearly indicate such.

In summary, the recommendations should include a section relating to whether or not the company has made changes in accordance with the disclosure made at issue of a policy. In the absence of specific disclosure, the recommendation should indicate whether the underlying experience of the company is being followed with respect to the non-guaranteed elements in the policy.

MR. CLAUDE THAU, MR. MARK HUG, MR. SHANE CHALKE (Letter): The Committee's draft Recommendations 13A concerning actuarial principles and practices in connection with dividend determination for participating policies are generally sound. We would like to comment on the aspects to with which we disagree.

1. Section 12. Separation of Accounts
   The section requiring a separation of accounts is improper. As long as a company is able to evaluate its experience factors for its par business, separation of accounts is unnecessary. Using an asset share method, a company can decide on how to change its dividend scale for its policyholders. The asset share would require the ability of the company to determine investment rates, policy loan utilization, lapse rates, expenses, mortality, etc. for its par business. However, none of these factors require a true separation of accounts in order to be determined. Also, those methods specifically approved in Section 3.3 to distribute divisible surplus among policyholders do not utilize separate accounts.

   The primary use of separation of accounts is to determine divisible surplus. Yet, Section 1.3 specifically states that the determination of divisible surplus is "not the subject of these Recommendations". The inclusion of separation of accounts seems inconsistent.

Throughout the rest of the Recommendations, all statements and principles are worded as suggestions or recommendations. However this section requires specific company procedures. If, for some reason, the subject of separation of accounts remains in the Recommendations, the wording should be made consistent with the rest of the Recommendations, transforming this section from a requirement to a recommendation.

2. Section 10.3.h. Adjustments to Dividends

Section 10.3.h. ("Adjustments to dividends are frequently made for a variety of special reasons such as ... to reflect amounts charged against the participating business for shareholder retention.") is too important to bury in Section 10.3. The other adjustments, such as pegging and smoothing, are trivial in nature since they only serve to alter the slope slightly or smooth the dividend scale. Furthermore, these adjustments are typically made after a preliminary scale has been developed. However, shareholder retention is more significant and is an important part of the dividend process. We recommend expanding this concept in another section (perhaps create 10.5.). This new section should include the general principle that the determination of the shareholder charge should be consistent with the basis implicit in the originally illustrated dividend scale. If the Committee so desires, we will provide preliminary wording for such a section.

3. Earnings Limitations

This topic is also beyond the stated scope of the Recommendations. According to Section 1.3, the Draft deals with the distribution of divisible surplus among policyholders. Earnings limitations, however, deal with the question of determining the amount of divisible surplus.

In addition, Section 12 could be interpreted to place shareholder rights in an inferior position when compared to those of policyholders. For example, the last sentence of section 12.2 suggests that shareholder dividends be reduced before the current policyholder dividend scale is reduced. Although this is a viable stock company position, (one which we in fact support), a stock company could justify either the proportional impact on adverse experience or the reduction of policyholder dividends.

With participating business in a stock company, the policyholder contracts with the shareholders. Based on this agreement, the policyholder participates in a significant portion of total profits. The shareholder, in turn, retains less risk on that block of business and need not expend as much capital to support that block. If expectations are not realized, the policyholder and shareholder will share in the loss or gain depending on the agreement made. Thus, if a company cannot maintain the current dividend scale, the shareholders need not forgo their profit in order to maintain that scale unless implied upon issue of the contract.

While we agree that stock companies should limit their earnings to shareholders in some way, we are uncomfortable with the wording of Section 12. We fear that some people may incorrectly infer that regulatory constraints are appropriate.

We suggest the following:

1) Define participating business as that business in which the policyholder is significantly affected by changes in experience.

2) Emphasize consistency in philosophy between a company's declared policyholder dividends and originally illustrated dividends.

3) Place more responsibility on the actuary to clearly disclose to management any implicit agreement made between the policyholder and the shareholder.

If for some reason, a monitoring of the relationship between shareholder and policyholder dividends remains a part of the Recommendations, we suggest that Section 12.2 cite "A significant ... measure" rather than "The most significant ... measure." Industry literature can be provided to underscore this suggestion.

The Committee's draft Recommendations 13B should address three underlying principles:

1. Redetermination of charges or benefits should be based on anticipated experience. A company should not attempt to recover past losses or distribute past profit.

2. Assumptions and policy factors should be consistent from one revision to the next within a block of business.

3. Assumptions should be consistent among various blocks of business. This does not mean that assumptions should be identical between blocks. Nor does this imply that profit should be consistent between blocks.

In many ways the Recommendations fail to recognize or clarify these principles. Our comments and concerns are explained below:

1. Scope of the Recommendations

Currently the Recommendations reference both the determination and redetermination of non-guaranteed elements. The Recommendations should only apply to the redetermination of elements and to their relationship to new business as indicated above. It is an actuary's inherent responsibility to price products in an appropriate manner. To restrict the actuary in the pricing process is improper.

We suggest that these Recommendations incorporate a statement to the effect that any practices or procedures differing from those outlined by the Recommendations are not necessarily wrong or likely to be wrong, but should be disclosed.

2. Section 2. The Continuity Principle

We are concerned with the wording in the definition of the Continuity Principle. Replacing "changes in anticipated experience" with "changes in the underlying experience" would

make the definition clearer. Section 13.1 points out that a company should not seek to recover past losses or distribute past gains in redetermining charges or benefits. Otherwise, the business should be considered participating and should fall under the Dividend Recommendations. We illustrate our concern with the following examples.

Example 1: A freak accident has caused actual mortality to increase in a closed block of indeterminate premium business. An actuary should not reflect this adverse mortality upon premium revision if such mortality is not anticipated in the future.

Example 2: An actuary should be able to anticipate smoker/non-smoker mortality differences in a block of business (where smokers and non-smokers were previously combined) without waiting for underlying experience to develop.

Example 3: A change in the tax law would automatically imply changing a company's anticipated tax factors even though underlying experience would not dictate such a change.

In all the above examples, an actuary would act contrary to the Continuity Principle as defined in the Recommendations. However, if one would replace "underlying experience" with "anticipated experience" in the definition, the intent of the definition would remain intact and consistency with Section 13.1 would be ensured.

3. Sections 2.1 and After - Experience Factors

Similarly, we are concerned with the use of the phrase "experience factors" throughout this portion of the Draft. "Experience factors" were defined previously in the Dividend Recommendations as elements that reflect "actual experience". To alter this definition in the related Non-guaranteed Element Recommendations is confusing and inconsistent.

The common usage of the phrase "experience factor" implies historical results. We suggest the term "anticipated factors" to be used in place of "experience factors". This term better identifies the difference between past experience (par) and anticipated experience (non-par). It also supports the recommendation which disallows the recovery of past losses or the distribution of past gains in non-guaranteed element policies.

Finally, Section 6.2 places undue emphasis on past experience in the process of determining anticipated factors. An actuary should always use sound professional judgment to project anticipated experience. The extent to which an actuary relies upon historical data to form his judgment is directly related to the actuary's view of how the past anticipates the future. Statistics are merely tools that an actuary has available to use when appropriate. Examples of "... determinable, available and statistically credible" data that an actuary may ignore are:

1) Past tax factors that are independent of future factors.

2) High interest rates over the past years that are not expected to continue.

3) Low lapse rates that are not expected to continue.

These are but a few examples of when the actuary has to use sound professional judgment despite the existence of "determinable, available, and statistically credible" data.

4. Additional Considerations

a. Policy Loan Utilization

The Recommendations do not include policy loan utilization as a factor for determining anticipated investment yields. This is an important item in light of the current economic situation.

b. Profit and Risk Factors

We agree with the recommendation concerning profit and risk factors but feel clarification is necessary. For example, there has been some discussion of "constant profit". As implied by the basic principles described at the beginning of this commentary, profit should not be constant over time but consistent over time. For example, a company may want to change its profit factors from a nominal basis to a real basis. This would be a reasonable approach, yet in violation of the "constant profit" concept.

MS. CATHY WALDHAUSER (letter): Following are some questions I have regarding the Society of Actuaries Committee Report on Theory of Dividends. I realize these are too late to be of use for the October annual meeting but perhaps they will still be of interest.

A. What kind of change in risk would justify a change in profit objectives?

1. I assume that a clearcut change in the operating environment, such as a change in the tax treatment of surrender proceeds, might warrant a change in profit objectives.

2. Are unprecedented high interest rates, and the resulting increase in surrenders, a risk that should be covered out of original profit margins? What about a fundamental change in the way society views inflation and interest?

3. What is meant by "profit objectives"? Target surplus? Investment margin? Premium margin? Internal rate of return?

B. Shouldn't it be legitimate to consider the following factors when revising charges or credits for non-par business?

1. Competitive pressures for different classes of business?

2. Maximization of profits from total business in force? (i.e., most cost effective distribution of available resources, consistent with presentation of product at sale, rather than most "fair".)