RECORD OF SOCIETY OF ACTUARIES
1984 VOL. 10 NO. 2

DIVIDEND PHILOSOPHY

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Discussion of the latest Exposure Draft of the Committee on Theory of Dividends and other Non-Guaranteed Elements in Life Insurance and Annuities and of other related developments in this area.

MR. WALTER N. MILLER: I am Walt Miller of New York Life. Our panelist is Jim Kemble, who is Special Projects Coordinator at the Continental Corporation and has a wide background of experience in both insurance company and consulting work covering both stock and mutual company exposure. Our recorder is John Tomlinson of New York Life.

The definition of open forum in the official Society definition in your program booklet says, "Open forums are designated when broad discussion of a topic is appropriate. These sessions are usually structured to include substantial audience participation." That's key. Jim and I do not have long prepared remarks, so how this session goes is really up to you. On behalf of both the Society and the Academy Committees, which are involved in this effort, I can build on that and say that the reason that we have been holding a number of open forums at Society meetings on these Dividend Philosophy issues is that they are important because of their potential for significantly affecting actuaries' relationships with management and because of their potential for significantly affecting company relationships with the public and with regulators. Here, I am talking about the disclosure issue -- these topics deserve a lot of thought because the road that we have started down is one we can't retreat from as a practical matter, but how we structure it is going to have a lot to do with the extent to which we might be successful in having a professional actuarial presence in connection with the resolution of some of these issues, or whether other people are going to walk in and do the job for us. And, whenever that happens, you can be sure that some of those other people may very possibly do things that we would not prefer. But if we leave the field to them by default, we have no one to blame but ourselves.

So, this is an open forum, it's not a teaching session. Jim and I will start off with building up a little of the background, but we are here essentially to listen and to have a dialogue.

The development of actuarial principles or standards or bases for disclosure is obviously a very sensitive and important subject. The way the process is supposed to be working is that the Society's Dividend Philosophy Committee is supposed to be working on suggested actuarial principles. It has been generally accepted that the public interface part is a job for the Academy, and so the Academy Committee that has been working in this area has taken principles developed by the Society Committee and in various ways attempted to translate them into standards of practice, mechanisms for disclosure, and so on. It's a dynamic process. The fact that the Society Committee is going to send a report to the Board of Governors at its next meeting saying

we would like to be discharged because we think we've done about as much as we can do up to now, doesn't mean that the process (particularly in the area that embraces all the types of products except traditional par) is not an ongoing one.

We've already seen a parallel situation where the Academy Committee, because it felt the pressure to act, and properly so in my opinion, came out with some proposed standards and guidelines which were picked up by the NAIC and are now reflected in some disclosure requirements on sales illustrations, and in an interesting and completely new addendum to Schedule "M", describing certain facets of dividend scale construction.

That was really done by building on the first draft of the Society Committee, because the process of translating this into standards and some disclosure items couldn't wait. In my opinion, the situation will continue that way. The process started originally in the mid-70's when it became quite obvious that, to put it mildly, there was nothing like uniformity in practices of companies in determining actual and illustrative dividend scales for traditional participating business. This came as a surprise to a lot of people. The Dividend Philosophy Committee did a study in 1974 based on a survey they sent to many mutual companies -- that confirmed this. And from then on, it was felt that there really was a need to start bringing some order to this situation, or the diversity in practice would probably continue to spread unchecked with unfortunate results, perhaps, for all of the players in the game, the actuarial profession, companies, regulators, and the public.

Associated with the efforts to set up some suggested principles and then practices for participating business, were the special problems created by the fact that stock companies issue par business also -- broadly speaking, in two main types. One is run very similarly to the way a mutual company runs its par business. The other type of stock company "par" has been described as being "par" in name only. In other words, the principle that through dividends, the cost of the product should be adjusted over time to reflect changes in experience, was never intended to apply from the beginning by the companies issuing these types of coverage. Let me make very clear that when I say that, I state it as a fact and not as a claimed defect of this type of business. But it still had to be treated as "par" because of the way the emerging body of laws and regulations defined participating insurance. If you have the dividend mechanism, broadly speaking, you have a par policy. But, it was recognized that special attention had to be paid to those situations.

The remaining area -- and looking forward, here's where all the action is -- is all of the rapidly proliferating types of coverages that could be defined as "other than traditional par". It includes all sorts of interest-sensitive products, Universal Life, and so on.

In the Fall of 1982, the Society Committee came out with its first draft of proposed actuarial principles for both types of business. Then, based on comments received in open sessions like this and via mail and phone, the Society Committee came out with a revised draft which was discussed in a rather interesting session at the Society's Annual Meeting in Florida in the Fall of 1983. I think it's fair to say that there was not much disagreement at that point in terms of the basic thrust of the so-called 13A recommendations covering par policies.

There was a very considerable and significant amount of comment, some of it quite adverse, relating to the then current version of the proposals on the so-called 13B draft for policies other than traditional par but with non-guaranteed pricing elements -- the new wave of products -- the real world. Since then, the Society Committee has been trying to fine-tune the material on par. It has done so, and hopes that by the time the Board of Governors meets this Fall, it will be accepted that this Committee has done its job on par at this time, and that includes par issued by stock companies.

So, there have been a number of fine-tuning changes in our current version of this draft from what was exposed last Fall, but to me there are only three significant ones. First is that the section on termination dividends was expanded to be more specific as to certain types of practices that fall into the termination dividend area and certain disclosures that an actuary should make in his report to management. This consisted primarily of material that was picked up from the Canadian Institute of Actuaries draft of actuarial principles on par business.

The second change is one which could have the potential for strengthening the draft considerably. One of these items in the prior draft says that it is the actuary's duty to include specific mention in the report to management if he thinks a situation exists where there is a substantial probability that the current dividend scale can't be maintained in the near future, or that the current illustrative dividend scale can't be paid, because of expected adverse experience. The change that was made in this area was to take out the phrase, "because of expected adverse experience"; with this change, the draft now asks the actuary to put in his report a statement that whenever he believes that there is a substantial probability that the current scale can't be maintained, for whatever reason, this disclosure should be made in the report to management.

The third item is that after re-examining the situation, the Society Committee, in addressing the question of par business issued by stock companies, certainly recognizes the fact that there are types of this business that are very different from traditional par. However, the Committee has concluded that there is no basis to try to segment par business from the standpoint of actuarial principles. If there is to be recognition of this situation as far as standards of practice are concerned, this should be up to the Academy Committee. I think it is fair to say that while the Academy Committee is still considering this question, their current thinking is that there should not be any differentiation in standards either. If this is the approach, there will be a need for some transition period in which companies that offer the "non-traditional" type of par coverage can make the swingover, if they desire.

I'll turn now to Jim Kemble, who will cover where we are on the question of policies with non-guaranteed elements -- the new wave, the real world.

MR. JAMES W. KEMBLE: Thanks, Walt. My purpose is to discuss the recommendation which has a nice long title: "Recommendations Concerning Actuarial Principles and Practices in Connection with Individual Policies and Contracts Containing Non-Guaranteed Charges and/or Benefits." In the original draft this was labeled Recommendation 13B, but I think since 1982, the Society has made some changes in its procedures, so this particular numbering scheme doesn't apply any longer. I personally am pleased since I get terribly frustrated when lawyers, particularly, begin discussing tax

benefits and legal subjects in terms of IRS code numbers instead of the appropriate descriptive name.

My discussion, to make it easier for me, is going to be in the form of a series of questions and answers. Hopefully, they are arranged in some sort of logical sequence.

The first question is, what does the Recommendation cover? Sections 1.1, 1.2, 1.3 and 1.4 set forth the coverage. They specifically include Universal Life and Indeterminate Premium contracts, and they make provisions (the big catch-all) for all other policies for which charges or benefits may vary at the discretion of the company, including so-called excess interest contracts. We have to be deliberately vague in some of these things because we do not know what the next contract which should be covered by this recommendation will be like.

The Recommendation applies only to individual life insurance policies and annuity contracts. Other contracts have not been considered to date. I will say that, somewhere during our deliberations in the Academy Committee, someone mentioned such things as Guaranteed Renewable Health policies, and we all shuddered and decided that perhaps we'd get to that some other day. But in order for us to come up with something which we can be definitive about, we had best restrict ourselves to individual life and annuity policies initially. The Recommendation applies to policies written as non-par, par (including the non-traditional kind where there is really no intention of changing the dividend schedule, and some of the more recent ones which were issued with no expectation of paying dividends), and any combinations of the above.

Policies which are participating and also have a non-guaranteed element (if there are such in existence) may be subject both to these recommendations and the dividend recommendations that Walt Miller was discussing.

This Recommendation is intended to cover the determination of charges and benefits at the time a policy is issued, and their redetermination at any time after the issue date. The Recommendation specifically excludes benefits or charges that are directly linked to a separate account performance or to a defined index. Other elements in the same policy, however, may be covered by the recommendation. It depends on the provisions of the policy.

Secondly, what does this Recommendation require? In reply, let me read Recommendation 1, which is actually Section 1.6. "Whenever an actuary advises an insurance company on non-guaranteed charges or benefits, a written report should be prepared which documents the advice. Such a report should include a statement, describing the framework of facts, assumptions and procedures, upon which the advice was based. In particular, if assumptions and procedures are used which deviate materially from those prescribed in these recommendations, the actuary should include in the report, an appropriate and explicit statement with respect to the nature, rationale and effect of such deviations."

Now, I want to emphasize that this report is to be prepared for the benefit of the actuary's client. In nearly all instances, whether you are a staff actuary or a consulting actuary, the client will be the management or the board of directors of the company. And, I would also like to note that the

emphasis in the document should be on any deviations from the principles of the Recommendation. Thus, the actuary is required to make disclosure to those responsible for final decision-making, with emphasis on substantial deviations from prescribed principles.

How does this Recommendation differ from the dividend recommendation? Well really, it differs in the same manner as the nature of the non-guaranteed contract differs from the nature of the true participating policy. Participating policy dividends, to make a very general statement, are determined by application of the Contribution Principle, under which the company determines the amount of distributable surplus allocable to each policy on the basis of its past experience in relation to the experience of all other policies.

In contrast, a policy with non-guaranteed features carries a current premium which, when collected, is really intended to cover only the related benefits, expenses and profits; there is not really intended to be included a margin for distributing a policy dividend; any future changes in these elements will be based on anticipated future experience.

In order to better define this difference, the Recommendation includes a newly named principle, the Continuity Principle. It's contained in section 2 of the Recommendation and I am going to read it for you. I'll read the preamble and then the Recommendation itself. "The basic principle of non-guaranteed charge and benefit determination is that any increase in non-guaranteed charges or reduction in non-guaranteed benefits, from those illustrated at issue, should be based on changes in the underlying anticipated experience. This is said to be the Continuity Principle. In a broad sense, it assures the degree of fair treatment required when charges or benefits are not guaranteed." The Recommendation reads, "The use of the Continuity Principle in the determination and redetermination of non-guaranteed charges and benefits is an acceptable interim standard. The actuary's report should state whether or not the Principle has been followed. If it has not been followed, the report should explicitly state any deviations from that rationale."

Note that the use of the Continuity Principle is labeled an acceptable interim standard. This is an acknowledgment, I think, on the part of the Society Committee, that these products are still new and continually evolving, and since that is the case, we may eventually see changes before arriving at a generally accepted practice, which is the term used in the dividend recommendation. (That's the way I read that particular provision.)

The Recommendation also differs from the dividend recommendation in its application. When is it applied? It's applied only when charges are increased to a level above, or benefits are decreased to a level below, those which were illustrated at issue. The 1982 draft of this Recommendation provided for application of the Continuity Principle for all changes. This draft allows for improving the policyholder's position without applying this Principle or these Recommendations. Here's my unofficial version of the philosophy underlying this approach: When you buy a non-par policy, a certain level of charges and benefits has been illustrated to you. The insurance company is under no obligation to make any change in these elements for the duration of the policy. However, under those policies which contain non-guaranteed elements, the insurer may change any or all of these elements to reflect its expectations with respect to future

experience. To the extent that such changes improve the policyholder's position, there is no obligation to consider the Continuity Principle. To the extent that the changes will result in the policyholder being placed in a less favorable position than was illustrated at issue, the actuary's report needs to recognize the Continuity Principle and to specifically indicate where it is not being applied in making the change.

Within these Recommendations, there is a Recommendation 14. Its preamble deals with the profit element. Here are a couple of excerpts from 14, and then its preamble:

"Although the absolute amount of any provision for profit and risk included in the determination or re-determination of charges and benefits on different classes of policies with non-guaranteed elements is not the subject of these Recommendations, changes after issue in the level or structure of this provision within a specific policy class is such a subject." So Recommendation 14 says: "The actuary's report should disclose how the profit and risk provision is expressed in the non-guaranteed charge and benefit determinations for the policy classes covered by the report. If, in redetermining non-guaranteed charges or benefits for a policy class, the provision for profit and risk is changed in overall level or structure, this fact must be disclosed in the report along with a statement of whether, in the actuary's judgment, the change, if an increase, is commensurate with the change in risk or whether the increased charge level is at or below that applicable to otherwise comparable new business products." There is a little bit of hedge in here, but basically what it says is that if you are going to increase your profit level on policies that you issued with certain illustrations, and if that is going to cause you to increase the charge to the policyholder or reduce the benefits, you have to disclose to your management that that is what you are doing in making these recommendations. They have apparently said that it is okay if all you're doing is raising your profit level to that level which you have now established as desirable for new business. You are not really violating the Continuity Principle if that is what you do. Again, I want to emphasize that this report is for the benefit of the company's management and board of directors. They are the people who make the decisions, but they need to have this information in order to make proper decisions.

How are the Recommendations to be applied in practice? Well, there are details of suggested methodologies which are quite similar to those in the dividend recommendation. The derivation and application of assumptions center around the use of policy class, policy factors, and experience factors. I suggest that you read these details carefully. I don't believe you'll find any particular surprises in them.

It is usually easier to understand a subject like this if you have some specific illustrative cases. I have a few such cases which, for simplicity, are based on an indeterminate premium YRT policy which happens to have an original 3-year premium guarantee. We've done some work on these cases in our Academy Committee. We haven't decided yet whether we are going to have some interpretations or exactly how we might come out with some of these things, but for our own benefit in trying to see how these principles would apply in practice and in establishing some standards, we decided this is the best way to do it.

The first scenario is very easy. Suppose the anticipated experience factors

remain at the level assumed at issue -- obviously something that is never going to happen, but it is the easy one to think about. Any increase in current premiums after the third policy year must be disclosed as a departure from accepted practice. I guess I should say from interim standards. A reduction in current premiums, which would obviously reflect a reduced profit objective, could be accomplished within the guidelines.

The second scenario: One or more of the anticipated experience factors trends in an unfavorable direction. Current premiums beyond the third year could be increased to maintain the original profit objective on a prospective basis. However, any losses incurred in the interim, and in particular, any losses incurred during the guaranteed period, could not be recovered without departing from the standard practice. The actuary's report would have to disclose the amount and nature of such recovery. In other words, you can make changes in anticipation of future adverse trends, but it doesn't seem proper to recoup past losses without at least disclosing that fact.

The third scenario: Anticipated experience factors improve. There is no need, under the recommendations, to reduce current premiums for existing policyholders; however, those of us in the practical world know that for competitive reasons it's probably a good idea to do so. So, if you can get by without reducing the premiums on a current block of business, it's not necessary for you to reduce them if your experience improves. That's been the practice of non-participating business forever. Under current competitive circumstances, however, with the non-guaranteed type policy, you had probably better take a good hard look at whether or not it is practical to maintain the current level.

The fourth scenario assumes that management increases the profit objective, but no change in experience factors is anticipated. Current premiums may be increased for new customers to meet the higher profit objective. Premiums on existing business may also be increased to raise profitability to the level anticipated on new business, subject to the actuary's report identifying the change as arising from a change in profit objective, and stating whether the premium increase is commensurate with any increase in risk (which presumably is not the case here), and whether the prospective profitability of existing business is at or below the profit level for comparable new products. It should, according to these principles, remain no higher than the level for new business.

The last scenario: Anticipated experience factors improve and then deteriorate. This is to illustrate the fact that in these principles we say, "...to the level used when the policy was issued, or for the illustration given the policyholder when the policy is issued." If premiums had been reduced during the period of improving experience, they could be increased back to the level of the original illustration without any applicability of this Recommendation. If current anticipated experience factors are in the aggregate less favorable than originally assumed in the pricing, current premiums may be increased above the level originally illustrated, to restore the original profit objective within the guidelines of this Recommendation. I think that is enough from this part of the room, Walt.

MR. MILLER: Just let me briefly pick up on where the Society Committee may be going on this question of principles for policies with non-guaranteed

elements. To do that, I would like to first back up to the principles that we think are reasonably well agreed on for par business. As I see it, here is what we're doing in establishing a set of actuarial principles and then practices: We are drawing a circle. It's a large circle because there is legitimately a lot of diversity in practice. We try to define the circle and we say that one thing that you, the actuary, need to do in your report, loud and clear, is that if you are outside the circle, you have to say so and you have to defend why you are. It's not necessarily wrong to be outside the circle, but if you are you have to tell your management that you are, and tell them why you're there.

In the real world, the basic thought behind this approach is that we should try to put outside the circle situations where there are differences in pricing between in-force policies and corresponding new policies and those differences are not justifiable by differences in experience. To put it more crudely, but I think more accurately, what we're really talking about is, let's try to do the best we can to see that bait and switch tactics are outside that circle.

Now let's go to the new wave of products. Broadly speaking, if you take all the approaches to this question that have been thought of or discussed, and put them along a line, one end of the line covers a number of possible approaches which are characterized by a basic philosophy that says, we know that the principles we have established for participating insurance are not directly transferable to this new class of policies, but let us try as hard as we can to have the underlying philosophy transferable. In other words, just as with par, let's draw a circle and let's put "bait and switch" outside that circle.

At the other end of the line, and this represents the thinking behind a lot of the criticism that the 13B draft has received, is the philosophy that says, "Well maybe we're going to get there some day -- maybe we are going to be able to define a circle for these policies, but it's too early. We just don't know that the principles are. The world of products out there tomorrow will be very different from the world of products out there six months ago, and if we go six months or a year or more into the future, who knows what we'll find. And so we shouldn't draw a circle right now. But, let us still be concerned about setting up a mechanism under which an intent to be allowed to follow a 'bait and switch' tactic, if the company desires, is something that really has to be disclosed, and certainly if that ever happens in practice, it ought to be disclosed."

The Society Committee, at its meeting on April 26th, agreed that we would attempt to develop and evaluate a modification of the 13B draft to reflect the latter feeling. And, maybe one approach that can be taken is one of definition, in other words, define what are the company's pricing intentions at issue if and when they are changed. Maybe it can be done by having answers to key questions in the actuary's report to management. One of those questions might be, "Do you intend to reserve the right to recover past losses in a repricing?" One of those questions might be, "Do you intend to follow the Continuity Principle in terms of the relationships for pricing or repricing of inforce business with new business?" Another such question might be, "Do you reserve the right to change profit margins, or, to put it another way, to change prices on either new or inforce business on a basis that is not fully justifiable by changes in anticipated experience?" I don't know where this approach will wind up. Harry Garber

(the Chairman of the Society Committee) and I have the job of coming up with a draft (that might follow these principles) to be discussed at the Society Committee's next meeting. The question of possibly using this approach has also been discussed by the Academy Committee.

We thank you for listening so far. We still have half the time of this session left, and from now on it's in your hands. We hope that some of you have questions, comments, brickbats, whatever.

MR. HARRY H. COHEN: There is an important issue which I do not see addressed in the exposure draft. It is the question of non-determinate premiums (i.e., adjustable premiums). We are selling large amounts of business of this type, and the actuary has the responsibility of recognizing current trends in the subsequent recalculation of these premiums. If there is a significant increase in interest rates, the company's theme in selling that policy is that premiums would have to be reduced to reflect the higher interest rates. However, the company does not have to reduce its premium rates, and it is not required to under these guidelines. The exposure draft does not address this question, and I think it should. You as a professional may have a different opinion, and I think that is something we have to think about.

My concern is that more and more companies are issuing policies which they call non-par, but which call for the reflection of mortality, or the reflection of current interest and current expenses. As these policies become a higher and higher proportion of the inforce of some companies, for us just to treat these policies as traditional non-par policies may not be the best approach, and for us to include in the recommendations only the increase in mortality, or the increase in the factors that would reflect increased premiums or decreased dividends, is one-sided for these so-called "non-par" policies.

MR. KEMBLE: Walt, we had some discussion from stock company actuaries who were very vociferous in the other direction. This happened at Society Committee meetings, and I am not sure I can report accurately what they said. I do know that the 1982 version said "changes" and the 1983 version says, "You must report on changes which adversely effect the policyholder."

MR. MILLER: Remember that the first set of philosophies I enunciated is basically characterized by a feeling that to the extent feasible, the principles that have been developed and pretty well accepted for traditional par should carry over into the new breed of contracts. Now, the point Mr. Cohen raised is a legitimate one, and it's very much related to this. Jim Kemble indicated, the 1982 draft reflected the feeling that par-like principles should be carried over to the extent that we should try to "make sure", or at least put inside the circle, that the policyowner would probably get pretty close to all the benefits of improving experience, were that to occur. The reason the change was made, for better or for worse, is that even those on the Committee who tended towards this line of thinking, finally agreed that realistically, it was just going too far to insist as a matter of actuarial principle that the policyowner always benefits when experience improves. Now, that may sound very loose to some people, especially those whose experiences are deeply rooted in the determination of dividends for traditional par policies, but remember that there is a considerable body of law and regulation that goes with the fact that this principle (that any improvement has to be reflected) has become widely and

long-accepted for par. No such law or regulation really exists with respect to the new breed of policies.

Let me ask the audience this question. One term that the respective committees have used in discussing one of the possible approaches, or one of the possible management philosophies, for this type of business, is the "caveat emptor" policy. This is a policy that says up front, okay, you're buying this policy on the basis of a certain illustration. We want to tell you up front that this illustration may not be worth the paper it's printed on, because the company reserves the right to change the pricing of this policy at any time for whatever reason, with no necessary relationship to changes in either actual or anticipated experience. If you think that gives the company too much of a whip-hand over you, that's your business. You don't have to buy the policy. But, if you are going to buy it, understand that's the deal.

Now, my question for the audience is, if you are trying to draw a circle of actuarial principles and practices, should the caveat emptor approach be inside or outside the circle? Could we have some expression of opinion on that? Because it's one that is pretty basic to the considerations and discussions in determinations that these Committees are involved in now, and we would very much like to have your input. You have the right to change your mind. Would anyone offer any thoughts on that? Should the "caveat emptor" policy be within the circle? Could we have a show of hands? How many of you think it should? How many of you think it shouldn't? I see that the people who think the "caveat emptor" policy should be outside the circle are in the majority by about three to one.

MR. MICHAEL B. HUTCHISON: You probably have to put your "caveat emptor" policy inside the circle, but I think you need to establish the disclosure principles that go with it. I don't think you can have it inside the circle without fairly severe disclosure requirements. I don't think we actuaries are godly enough to mandate absolutely that it should be outside the circle.

On a bit of a tangent, here's a question relating to changes in the mutual company that we know and love today. Historically, the mutual company has been the embodiment of the Contribution Principle from which have flowed the 13A Recommendations. But in this day and age, are we seeing a change to where the mutual company is, in fact, a holding company for downstream subsidiaries selling 13B style non-guaranteed products? If so, that creates an area of concern for me, which, perhaps, should be addressed as to the consequences as the par business is cannibalized by the downstream non-par subsidiaries. Should the surplus in the mutual company be distributed to the policyholders now, or tomorrow when there is none?

MR. MILLER: That's a good question, which can be addressed in various ways. One thing that has been fundamental to the development of the principles and recommendations to the point where we are so far, is that for participating insurance we were talking about how to divide the melon that has the name divisible surplus. We were not talking about the size of that melon. In some of the language Jim read you earlier, he indicated that's the reason why we say, loud and clear, up front, in the par recommendation, that the subject of the amount of divisible surplus is <u>not</u> the subject of these recommendations. That is strictly management discretion. The same principles apply, we believe, to a number of associated questions that arise when you are talking about determination of prices and changes in pricing

for the policies with non-guaranteed pricing elements. So I guess my answer, Mike, would be, "Yes, it's an important issue; it should be addressed, but we have enough trouble trying to do what we are doing now without trying to bring that one into the arena of principles and practices for dividends and non-guaranteed pricing elements."

MR. JAMES J. MURPHY: You referred earlier to the action the NAIC took in relation to earlier drafts regarding disclosure, and particularly the changes in Schedule M. With respect to the direction we seem to be going with the non-guaranteed benefits, would you see perhaps a similar approach to disclosure through the annual statement or some similar vehicle coming out for these products in terms of disclosing their intent relative to the pricing of products as a way to, perhaps, not police but at least tell the public, if you will. Your emphasis has been on reports to management, but is that a direction that it might go? This sort of relates to the question you had, Walt, in terms of the "caveat emptor" policy. There, I think, you're saying specifically that there has to be disclosure to the client, the purchaser; here, whether or not you put that kind of policy in your circle, the direction, I hear you saying, is that there has got to be some disclosure, presumably to management, about the intent of the pricing policy. Would that be picked up perhaps in another step by the NAIC?

MR. KEMBLE: My reaction is that, while it is definitely a possibility, I would like to see it not become a fact, primarily because in establishing these prices or benefit levels, we are talking about anticipated future experience and not about distributing what we have already earned on this block of business. My personal feeling is that we are beginning to get into some areas which are really sort of proprietary. I don't really want you to know what kind of mortality I'm expecting or what kind of expenses I'm expecting to use in the future, or to incur in the future in administering my policies. I'm not sure that public disclosure of that is desirable. I will say this, that if we make a report to management or our board of directors, there is no way, from a practical point of view, that we can avoid the regulators having a chance to look at that. And -- again, assuming that the regulators are honest people of integrity who understand their responsibility -- I don't see anything wrong with that, because there is an element of fair treatment of policyholders here. As a person who spent most of his time working for stock companies, I can tell you there were many times when I would like to have had that kind of club to use. On the other hand, I don't really believe that is in the realm of public information.

MR. MILLER: Do you want to respond to that, Jim, or do you first want to hear from me?

MR. MURPHY: I would like to make one quick comment. My intent is that I probably wouldn't expect the regulators to require a detailed disclosure of the assumptions or the anticipations, etc., but rather the underlying philosophy the company is using. For example, the question that Walt mentioned -- the company intends to use the Continuity Principle. That would be a statement. Or, the company does not intend, or the company intends, to be able to recover past losses in future changes. I would expect the regulators to require that kind of a philosophical statement, rather than a detailed disclosure of the underlying assumptions that they anticipate when they price.

MR. MILLER: Thank you, Jim. My own view on your question is very strong and I therefore have to say at the beginning that it is not shared by all of the people who are on these respective Committees or who have participated in some of the discussions. I feel very strongly that anyone who thinks that all we are talking about is an actuary's report to management, is just kidding themselves. What we are really talking about, in the real world, is setting up a process that is going to lead to regulatory requirements for disclosure of certain practices, and depending on whether the circle is drawn as all-embracing or not all-embracing, we are going to be talking about disclosure of those practices in a context that could have a negative connotation.

In other words, if it's not an all-embracing circle, there really is something to a company having to say, this dividend scale in some respect was not constructed in accordance with accepted actuarial principles. That's a very different connotation than a mere disclosure statement.

In other words, it makes a difference whether you say (1) this is a "caveat emptor" policy (which means thus and so) or (2) this is a "caveat emptor" policy (which means thus and so) and such policies are not provided for within the actuarial principles regarding the determination of pricing. The reason many of us think that it is proper to run the risk of disclosure of proprietary information is something I mentioned earlier this morning -- that something like this is coming along and if we don't establish a professional actuarial presence in this area, other people are going to do it and they are not going to know as much about the process as we do. However we feel about the result that the professional actuarial community is going to come up with, we may well feel worse about the results that somebody else might come up with. A prominent actuary who is a state regulator in the United States has been saying loud and clear, "You guys have to move on this non-guaranteed element question, because if you don't, the NAIC might, and they might do something stupid." The judgment that all of us have to make is, is this game worth the candle? Are we willing to accept that risk and that worry for the sake of establishing a professional actuarial presence in an area, where, make no mistake, somebody is going to come in and fill that vacuum. But that's for each of you to think about, and it's a very important and by no means clear-cut situation.

MR. KEMBLE: I don't think I can quarrel with that, but I still would tend to resist a rapid move into full disclosure of these things. To the extent that we're talking about how we are treating different classes of policyholders after we have told them we are going to treat them in a specific way, public disclosure is going to come one way or another.

MR. RICHARD H. GUDEMAN: I know that there are a number of mutual companies -- small ones generally -- that for 20 or so years now, have not changed their dividend scales on existing policies. While the interest rate assumption at time of issue was 4 1/2% to 5%, some of these companies are now earning a 9% to 9 1/2% portfolio rate. Realistically, what do you think will happen to such companies?

MR. MILLER: Well, it's not definitive yet. Remember, I commented on it: The way the thing seems to be going now, is that the Academy Committee may be picking up on the Society Committee's view. That's not decided yet. If that scenario comes to pass, what will happen is that those companies will have a choice between the alternatives of (1) either revising their approach

to dividends within whatever transition period is set forth, or (2) for good and sufficient reason, sticking where they are. Their value judgment could be that the benefits of continuing on this approach for dividends outweigh whatever disadvantages might come from having to make some disclosure that dividend scales are not in conformance with actuarial principles and practices. I suspect that the answer would be different for different companies. How do you react to that?

MR. GUDEMAN: I would say in that case, it really doesn't have much teeth, because there are a lot of cases of clear violation of any Contribution Principle or Continuity Principle and if all the requirement does is to say that there has to be disclosure to management, what is disclosed will never get to the policyholders.

MR. MILLER: Let me make it very clear that when I was talking about disclosure, I was talking about the end product being disclosure of some of these things to the public. In my opinion, it will result in public disclosure if it goes this way. Comments were made at the last Society Committee meeting, that it is known that a couple of stock companies that have followed these procedures in the past, are starting to change them in the expectation that this will come about. But that doesn't mean that they have to, and we're not trying to make them. We don't have the legal right to make them or anybody else do anything. That's why, in my mind, in terms of what really can be accomplished by a professional effort, disclosure is such a key item. You can't force people to do things. You can only make them realize that if they do certain things they ought to be willing to have others know about it, including the public.

MR. KEMBLE: Dick, I think you were talking about small mutual companies, and I think there will be disclosure in Schedule M in some instances which, perhaps, some consumer advocates or knowledgeable policyholders will pick up. But I think we have to be realistic and recognize that just as not all policies with a 4% policy loan interest rate have been loaned to the hilt, there are a lot of policyholders who are not going to be as aware of the treatment as they should be. And I don't know really in a practical sense what can be done about that. I think that the person who calls himself a professional actuary, and who continues to work for a company which follows these practices, has a strong need to search his own conscience. I do firmly believe that if we actuaries (as Mr. Day said the other day), as the people who really know what this business is all about, haven't got the courage to speak our convictions once in a while and let our management know what we think of what they're doing, we can't very well blame the regulators or the lack of information in the annual statement and so forth, for the continuation of those things.

MR. GUDEMAN: Jim, in response to that, all I can see is that I spoke my convictions to management, and then walked away.

MR. KEMBLE: I understand Dick, and I admire you for that.

MR. MILLER: It's another example of the dilemma that faces many professional people, and in professions other than ours. Because, any time you want to call yourself a professional and where you would claim some identity for that profession, inevitably you are going to run into conflict between your professional hat and your hat that has on it the label of your employer who pays your salary. One thing that the framers of this approach within the

professional actuarial community have hoped is that the development of this process may, in some cases, give the actuary considerably more of a wedge with his employer than he had before. In other words, at least in some situations, in addition to the options -- stay here and keep your mouth shut, or walk out the door -- there is another option which is to say to management, I just want you to realize that if you insist on following this policy, with respect to pricing this block of business, the world is going to know about it. Now, are you willing to rethink it on that basis? Not always, but sometimes, we are hopeful that that should help the actuary. We shall see.

MR. A. ANTHONY AUTIN, JR.: The mutual companies have just gone through their first filings of annual statements where the actuary had to file a supplementary report to Schedule M. Has there been any early reaction on the part of anybody to the results of that process? Either state regulators or insurance companies or the Academy or Society Committees?

MR. MILLER: I haven't seen any compilation of how these things came out. Have you, Jim?

MR. KEMBLE: No I haven't, but I think that's a good question; I think we should research that very quickly.

MR. MILLER: It's possible to say that the collective returns, when they are all tabulated, are going to say, "There's nobody here but us intense followers of the Contribution Principle." But, at least, if that be the case, we hope that actuaries will realize that there is more responsibility on them when they make that statement now than when they used to. But real world pressures are interesting. No question about that.

MR. KEMBLE: How did you find filling that questionnaire out; was it a painful process, Tony? Or, did it come pretty easily?

MR. AUTIN: As in any developmental effort which you're doing for the first time, you're faced with some questions you haven't answered before. But in our case we resolved all those questions and did file a report.

MR. KEMBLE: Does anybody else have any experience that might be helpful to us?

MR. MILLER: There really were about three fourths of the hands in this room a few minutes ago, raised in support of the proposition that on the "caveat emptor" policy, we should somehow draw the circle to exclude that policy, and we heard one expression of the opposite viewpoint from Mr. Hutchison. Would any members of the majority in the audience care to tell us why they voted to draw the circle that way? I think it is the instinctive way to go, for anybody with a mutual company traditional par background. Maybe this discussion has provided some food for thought as to whether in the circumstances that we are realistically faced with, the understandable knee-jerk reaction really is the right one.

MR. GUDEMAN: I voted in favor of keeping the "caveat emptor" policy outside the circle, but in the real world, who is going to be willing to disclose the fact that at the whim of management, we can change our profit objectives and change our cost and so forth? I don't believe that policy would sell with that kind of disclosure, so I think it would be very difficult.

MR. MILLER: If it wouldn't sell easily, maybe that would provide some inhibition against developing "caveat emptor" policies. I would also suggest that maybe the first time a situation surfaced, where it turned out after the fact that this really was a "caveat emptor" policy, except it wasn't properly stated at the beginning, that could lead to some repercussions, too.

MR. MICHAEL B. MC GUINNESS: I just wanted to explain that I voted to keep this "caveat emptor" policy outside the circle, because of the way you phrased the question. Had you allowed for sitting on the fence, such as with further disclosure, then I would have felt it would be inside the circle, somewhat along the lines that Mike Hutchison suggested.

MR. MILLER: I apologize if I confused people in the way I phrased the question. Anybody else want to change their vote on account of this recognition as to what Walt Miller was really trying to say?

There's a common thread in that whether it's inside or outside the circle, or whether there's no circle at all, you start off by disclosure; in other words, the company intends to follow approach X. The difference is that if you draw a circle and you have something that's outside it, the consequence then, broadly, is the additional disclosure that approach X is not within the catalogue of actuarial principles and practices that have been developed with respect to this type of business.

MR. JOHN W. TOMLINSON: The recorder will now ask a question. Do the panelists, or does anyone in the audience, care to comment on the question of whether it's ethical for mutual companies to illustrate dividends for twenty or more policy years into the future, when we really can't see that far ahead?

MR. MILLER: Good question. I'm not sure that the draft bears specifically on this question. If you have a situation of a dividend scale that you really don't think you can uphold near term, that has to be mentioned. But that's not directly responsive to the point John made. I think that everybody realizes that credibility declines as you stretch out the years of the dividend illustration, or any illustration for a policy with a non-guaranteed pricing element. And it's not just dividends. On the Universal Life policy where you're illustrating 60 years at the current 11% or 12% interest rate, the considerations are no different from a regular par Whole Life policy where you're showing an illustration as to what may happen at age 65 on a policy currently issued to a kid age 5. The situation is the same. This is a concern. I have an even bigger concern, though, about what are the real world implications of trying to be the first of the financial services businesses that says, "We are going to foreshorten these illustrations." It's a good question, and one of concern, and one where there isn't a good answer right now except to (perhaps more and more reluctantly) stay where we are.

Mr. KEMBLE: I think that pretty adequately states it. We have the further problem now that with our cost disclosure rules and such other things that the regulators have promulgated, we have no choice.

MR. MILLER: That's an interesting point, because in the United States, state laws and regulations say that we have to provide a 20 year illustration when we sell a life insurance policy.

MISS GRACE V. DILLINGHAM: Laws and regulations can be changed. On the other hand, do you care to comment on what kind of a consumerist uproar there would be if we were perceived as trying to weaken the disclosure requirements?

MR. MILLER: Did you say agent, or consumer uproar?