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REGULATORY UPDATE

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- Risk classification
- Valuation and nonforfeiture activity
- Cost disclosure
- 1980 CSO concerns

MR. CHARLES E. RITZKE: The regulatory concerns and issues that will be discussed will cover a wide range of life insurance company activities. For example, the nonforfeiture issues to be discussed will affect how we are allowed to design our products. Valuation issues will affect reserve setting, investment strategies, financial reporting issues, and employment security for actuaries. The risk classification issues will affect how we are allowed to underwrite our products. Cost disclosure issues will affect how we illustrate, sell and issue our products.

At first glance, the topics we are going to discuss may seem somewhat distinct. Upon reflection, I think it becomes clear that the regulatory direction that each of these topics may take over the next few years will affect the direction that others may take.

Finally, I think this discussion on regulatory issues might be a little different than the ones you have heard in the past because all of these issues that are going to be discussed today are at a very crucial developmental stage and therefore the panelists' discussions will be much more than just a list of what states have passed what model laws.

PANEL DISCUSSION

Our first speaker this morning will be Bill Carroll. Bill is an actuary with the ACLI. He is going to be talking about current and future valuation and nonforfeiture concerns. Mel McFall will be our second speaker. Mel is a 2nd Vice President of Underwriting Research and Development at Lincoln National. He is a member of the Academy's Committee on Risk Classification. Mel will be bringing us up-to-date on the current status of AIDS, unisex and blindness legislation. Our last speaker will be Walt Miller, Vice President and Actuary with the Prudential. Walt is Chairman of the National Association of Insurance Commissioners (NAIC) Yield Index Advisory Committee, a former member of the Academy committee which developed recommendations on policies with nonguaranteed elements, a member of the Interim Actuarial Standards Board and a member of the Society's Board of Governors. Walt will be discussing the NAIC Advisory Committee's recommendations on yield indexes and he will also be discussing the IASB's recent recommendations concerning the determination of nonguaranteed elements in life and annuity contracts and the Academy's annual statement recommendations regarding this issue.

MR. WILLIAM CARROLL: My assignment is to update you on developments that could result in changes to our valuation and nonforfeiture laws. Any change could potentially affect all of you. It would affect the products that you sell, the financial statements that you prepare, the taxes you pay, and perhaps even the way you manage your assets.

Summary of Current Activity

Study is underway according to three schedules:

1. Interim solutions were developed by two groups working on "quick-fix" changes to the Universal Life Insurance Model Regulation. Proposals been have been received and further evaluation will be made by the NAIC in June.

2. Intermediate activity is going on within the Life Insurance Committee of the American Academy of Actuaries. It has a task force working on changes to the universal life model regulation (both valuation and nonforfeiture). It will report in June 1987, with the earliest possible implementation date of December 1987.

3. Two groups have begun longer range activity. An NAIC Advisory Committee is working toward reconstituting the entire Standard Valuation Law, bringing in all lines of business, and introducing the concept of the valuation actuary in that law. On the nonforfeiture side, the long range activity resides in a committee chaired by Walt Miller of the Society of Actuaries. That committee will revisit the work of the "Unruh Committee" and publish a paper discussing the underlying principles of the nonforfeiture law.

To put these activities in perspective and give you a feel for the possible outcome, I will first discuss the purpose and structure of the standard valuation and nonforfeiture laws. Then I will discuss the problems that are perceived and finally I will outline the current assignments that have been made in an attempt to find solutions.

Purpose and Structure of Standard Valuation and Nonforfeiture Laws

I am going to talk, generally, about the nonforfeiture and valuation laws simultaneously and only when necessary mention them separately. When I use the words *Standard Laws* I mean the NAIC Model Laws (acts of the legislature). When I talk about *rules* or *regulations*, I mean regulations adopted by state insurance departments.

The model laws date back to the 1940s. Their purpose was to establish uniform national standards and a minimum floor for both reserves and for equity values; and in the case of the nonforfeiture law, to include some required provisions. These laws were not meant to spell out the exact reserves that an insurance company ought to carry. They were not meant to tell you exactly what the cash values of your products ought to be. They were merely meant to define a minimum floor. Those who look for specific answers will be disappointed.

The structure of these laws is similar for both nonforfeiture and valuation. The laws define a method (the commissioners' reserve valuation method (CRVM) and the commissioners' annuity reserve valuation method (CARVM) and set forth the basis for interest rates and mortality tables.

Those apparent parts of the structure are most often focused upon. I have isolated three less apparent, but very important, aspects of the structure (there

are more no doubt) which are particularly important if we talk about making major changes. The standards are based on an issue year approach. Standards are defined as a function of issue year, and are not changed thereafter. That is not necessarily the right way to do it. There are strong arguments that valuation ought to be appropriate as of the date of valuation regardless of the issue date. Similarly, cash values which take account of experience under the policy and market conditions at the time of surrender may be more equitable than those preset at issue.

The laws are both detailed and conceptual. Precise values are defined for a simple whole life insurance policy. For everything else you are told to be consistent with the whole life formula. This balance between detail and general guidance has enabled the law to survive in a changing world.

The method is an individual one. It applies policy by policy. But only the aggregate results matter. This also has provided needed flexibility.

These aspects of the structure could be changed. The detail requirements could be reduced, or increased. The method could move from an individual approach to a more aggregate approach as we have seen in pension valuations.

In the 1980s dynamic elements were introduced into the laws to facilitate change. The commissioners were given the authority to make rules when these laws did not spell out exactly what to do. The interest rate standards were tied to an external index. Commissioners were given power to promulgate standard mortality tables. All of this was intended to make change faster, more efficient, and to avoid the need for frequent state legislative action.

Perceived Problems

Next, I want to move to the problems that are perceived by the regulators and others. Yesterday we learned, from our keynote speaker, the difference between paranoia and metanoia. The regulators, by nature of their position, have been labeled paranoid. Some visionaries see what the laws should look like far into the next century. They could be labeled metanoid. They see the future and plan backward; the regulators see yesterday's problems that they must

resolve and plan forward. Successful change will require these backward plans to jell with these forward plans.

What are the regulators' problems? Primarily with universal life and with the universal life model they find valuation standards to be inadequate. They point out that reserves frequently are less than cash values, future guarantees are not necessarily prefunded and have no impact on the current reserve. Rapid increases that take place in the future nonforfeiture values are not taken into account for current reserves. This is basically the same kind of problem that they have had since the last part of the 1970s. They would like to see a CARVM type approach applied to life insurance. They find the valuation complex, inadequate and difficult to deal with.

Similarly, for the universal life nonforfeiture standard, they conclude that there is no real standard. There are limits on either the interest rate credited, the mortality charges or renewal expenses. The only thing that is limited is the excess first year expenses. But why is that? It is because of the constraints that the law places on the process. The provisions that give the commissioners power to adopt rules provide that the rules be consistent with the Standard Nonforfeiture Law and the Standard Valuation Law. That consistency requirement was interpreted by the task force that developed the model to mean that the only limit which could be imposed was on excess first-year expenses. Consequently, all that is really being regulated by the Universal Life Nonforfeiture Law is the difference between first year and renewal expenses.

Other people see other problems with these laws. They see that it is difficult to design products. They see that required reserves frequently exceed the level of funding the company truly believes is necessary. There have been complaints about mortality. The standard mortality table is used, yet we have all kinds of nonmedical issues and guaranteed issues and the like. Regulators fear that perhaps some specialty companies might be troubled on account of this. AIDS claims must be provided for. The C-3 risk, which we saw at the end of the 1970s and in the early 1980s when interest rates suddenly changed, and we discovered that book values were dangerous and could cause problems for companies, must be considered. Any long-range solution of nonforfeiture will have to address whether or not preestablished guarantees ought to be required. There are a good deal of problems.

Attempts at Solution

I mentioned before the three kinds of solutions that are being sought. I will go over them with more detail. The quick fix or interim solution dealt primarily with the universal life model for both nonforfeiture and valuation. The hope was to put something together by last December which could be adopted and would be good for a short time. Two proposals were made. An ad hoc advisory group reporting to the NAIC Actuarial Task Force recommended a very carefully drawn out extra reserve in the event that a company guaranteed interest rates in excess of the valuation rate for more than one year. That recommendation has been tabled. Similarly, the NAIC Actuarial Task Force itself developed proposed changes to the nonforfeiture model based on practice in Pennsylvania and law in New York. Their proposal would have regulated the interest rates, mortality and surrender charges. That has also been tabled. Both interim proposals were tabled partly because the interim working group will soon make its report and it did not seem logical to adopt interim solutions with the intermediate group about to report. The intermediate group was having difficulty deciding what to do because they did not know what was going to happen with this. So my opinion is that the quick fixes which are on the table are dead and will not reemerge.

The American Academy of Actuaries Life Insurance Committee, charged with finding an intermediate range solution, plans to present recommended changes to the Universal Life Insurance Model Regulation at the June 1986 NAIC meeting. Their charge does not permit the committee to recommend changes in the law (acts of the legislature). They are limited to recommending changes in the universal life model. They are also constrained by the need to be consistent with the law. Practically speaking, any solution must also be acceptable to the industry and the regulators. There may be no answer that meets all of these constraints. In any event, they plan to report in June.

The groups working on the long-range solution are just beginning. A special advisory committee to the NAIC Actuarial Task Force has been charged to recast the Standard Valuation Law to incorporate the concept of the valuation actuary and to bring in all lines of business. The charge to bring in all lines of business includes solving the problem that the industry, the regulators, and their professional actuarial advisors now have of attempting to establish new health

insurance valuation standards. The charge is enormous. Work is at the very beginning.

A committee of the Society of Actuaries, chaired by Walt Miller, will revisit nonforfeiture principles. Most of you have probably read the work of the "Unruh" Committee, a previous Society Committee on Nonforfeiture Principles. This will be a revisit of that kind of analysis. What is the basis of equity? Is it retrospective or prospective? Does it look for equity between company and policyholder? Does it look for equity among classes of policyholders or individual policyholders? Should there be a nonforfeiture law -- why? Their work is also just at the early discussion stage. We will not hear from them until next year.

Finally, I think it is important for you as actuaries to keep aware of developments in this area. There are means available to everyone. These matters are covered by the Society of Actuaries Product Section newsletters and by the Financial Reporting Section newsletters. Recent issues have excellent articles. If you have not read them, you should. You should watch this in the future. Also ACLI bulletins will from time to time present matters that are currently being considered and call for comments. These are ways you can keep informed and become more valuable to your clients. It is you who must deal with these matters as they emerge.

MR. MELVIN C. MCFALL: In the last several years, we have seen an unprecedented level of legislative activity that affects life and health insurance underwriting. We will review some of that legislation, attempting to define its intent and its impact on the life insurance industry.

Before examining specific legislation, I think it is important to emphasize a couple of points about legislation in general. First, legislation seems to have changed its focus in the last 10 years or so. Much of the legislative efforts of the 1970s dealt with privacy. Privacy issues are important, there is no question about that, but to me they seem more procedural than fundamental. Much of today's legislation focuses on addressing perceived discrimination or promoting various types of equality even at the expense of some equity. Equity, as we all know, is fundamental to the risk classification process.

A second point that cannot be overemphasized is that increasing governmental involvement, inquiry and regulation is virtually inevitable. Because sound risk classification is so important, so fundamental, so essential to the operation of the insurance industry, we have to be prepared to fight ill-advised legislation when it does occur. We have to continue our efforts to educate regulators, consumers and legislators. We have to be prepared to respond in a timely manner as new regulations are passed.

We will now turn our attention to some specific legislation affecting the insurance industry in general and life and health insurance underwriting in particular. We will focus on legislation in three areas that I will label A, B and C: A for AIDS, B for blindness and C for sex, specifically unisex. Because of the importance and the urgency of the AIDS issue we will save it for last and try to cover the other two fairly briefly.

In December of 1984, the NAIC adopted a new model regulation on unfair discrimination on the basis of blindness or partial blindness. The model regulation was developed after the National Federation of the Blind introduced federal legislation to remedy what they considered to be discrimination against the blind on the part of the life and health insurance industry. The 1984 model regulation superceded a 1978 regulation that had been promulgated by that time in a number of states. There are two major differences between the 1984 model and the 1978 model.

First the 1984 model permits no distinctions to be made solely because of blindness or partial blindness, whether or not those distinctions are justified by sound actuarial principles or actual or reasonably anticipated experience. That wording comes directly from the regulations. In other words, we cannot consider blindness in itself as an impairment for underwriting purposes even if we have data indicating that blindness does present an extra risk. It is important to note here however, that we can distinguish and classify the risk based on the underlying cause of the blindness.

Second, the 1984 model makes it clear that insurance companies may not refuse to issue disability income coverage to the blind on the grounds that the policy defines disability as being presumed in the event that the insured loses his or her eye sight. This means we cannot use presumptive disability as an excuse

not to issue disability income insurance to the blind. The 1984 model has been adopted in about 25 states at this time. Nonetheless, the National Federation of the Blind continues to promote a federal regulation in this area. They introduced a bill in the House in 1986 that was cosponsored by Congressmen Mathias and Bates and I think they are expected to reintroduce legislation again in 1987.

Next, let's turn to unisex. While the unisex issue is not receiving the attention that it did a couple of years ago, there is still a considerable amount of activity. I trust that I do not have to remind most of you how important the unisex issue is to risk classification in general. If we lose on unisex, then what is next? If it is deemed unfair to charge men more for life insurance than women, then applying the same logic, isn't it just as unfair to charge 50-year-olds more for life insurance than 35-year-olds? It seems to me that our ability to classify risks can break down pretty quickly.

Thanks largely to the ACLI and the HIAA and a number of key people in the industry, federal unisex legislation has not been successful. Legislative activity at the state level continues. One state, Montana, now requires unisex pricing for all lines of insurance. Unisex pricing of property/casualty failed in Pennsylvania only because the governor's veto was overridden by the Pennsylvania legislature. At least 9 states considered unisex legislation in 1986 with Massachusetts perhaps being the state of greatest concern at the present time.

Having had limited success with federal and state legislatures, the National Organization of Women (NOW) has turned its attentions to the courts. NOW first filed suit against Mutual of Omaha in 1984 in the District of Columbia where they alleged that Mutual of Omaha's sex distinct pricing of individual health insurance violated the District's public accommodation law. It was a year ago that the District of Columbia Superior Court ruled against NOW. NOW has appealed that decision. In the meantime, NOW has filed two additional lawsuits: one against Metropolitan in New York and a second against State Farm in California. The results of those lawsuits bear fairly careful watching.

Next we will move to AIDS. I don't think it is exaggerating to say that AIDS related legislation poses the greatest potential threat to risk classification in the history of the industry. To date, 6 jurisdictions have passed legislation or adopted rules that restrict our ability to underwrite for AIDS. The most

restrictive legislation, of course, became effective in the District of Columbia on August 7, 1986. The D.C. ordinance effectively prohibits any kind of testing for AIDS.

California was the first state to enact legislation pertaining to underwriting for AIDS. The California law was enacted in April of 1985, and precludes insurance companies from asking about results of prior AIDS antibody tests, ordering antibody tests, or in any way using antibody tests in the determination of insurability. The enzyme-linked immunosorbent assay (ELISA) test and the Western blot test are both antibody tests that are prohibited in California. Insurance companies can use the T-cell test in California. The California Association of Insurance Companies is reportedly planning to try to get the California law changed or repealed in 1987. It is probably too early to assess their chances for success.

In July of 1985, Wisconsin passed an AIDS bill that was very similar to the California law. At the end of 1985, corrective legislation was passed in Wisconsin saying that if the state's epidemiologist determined that the antibody tests were reliable and if the insurance commissioner ruled that the antibody tests were appropriate for underwriting purposes, then antibody tests would be allowed. As you probably know, the Wisconsin state epidemiologist concluded in late 1986 that our antibody testing protocol was sufficiently reliable to be used in the underwriting of individual life, accident, and health insurance policies. To my knowledge, the insurance commissioner has not yet authorized the use of antibody testing in Wisconsin, but we are hopeful that he will do so fairly soon.

Maine passed a law in April 1986 that prohibits asking about prior antibody tests in an application. Insurance companies are allowed to order current antibody tests in Maine.

In October of 1986, the Washington Insurance Department adopted a regulation specifying that a prospective insured cannot be declined or rated substandard unless the decision is based on a Western blot test or another test of equal or greater accuracy. Washington also requires insurance companies' financial statements to take into account the effect and adequacy of reserves for AIDS and related conditions, and any other disease that does or may potentially constitute an epidemic.

REGULATORY UPDATE

This last December, the Massachusetts Commissioner of Insurance issued a policy statement that would prohibit insurance companies from using the AIDS antibody test in any way. We could not request information on test results, and we could not require applicants to submit to the test. The policy statement was followed up in February with a demand to 15 insurance companies for extensive information relating to AIDS underwriting. As of late February, the 15 insurance companies had retained counsel and were considering a suit to prevent the commissioner from enforcing the demand for documents and/or the policy statement. The ACLI may also be involved in litigation in Massachusetts.

We can expect further activity in a number of states in 1987. According to information released by the ACLI about a month ago, there are seven states that have introduced bills that would prohibit testing for exposure to the AIDS virus. These states are Hawaii, Massachusetts, New Mexico, Rhode Island, Tennessee, Texas, and Washington. At least six states have introduced informed consent bills that impose detailed preconditions to testing. These are Maine, New Hampshire, Texas, Vermont, Hawaii, and Illinois.

The NAIC has also been active in developing nondiscrimination underwriting standards relating primarily to AIDS. Their recommendations were released in December of 1986. The primary thrust of their proposal was to prohibit insurance companies from inquiring, directly or indirectly, about sexual orientation and to prohibit insurance companies from using sexual orientation in any way in the underwriting process. The NAIC proposal would permit questions on the application to determine whether or not the proposed insured has been diagnosed as having AIDS or aids-related complex (ARC). The NAIC was silent on the matter of testing for AIDS, so this issue was left to the individual states.

I might add that the importance of AIDS and its potential impact on the industry has prompted a tremendous amount of activity on the part of the ACLI and HIAA. The ACLI, for example, has developed an educational video tape relating to risk classification and contributed to an educational tape on AIDS. Surveys have shown that many consumers do not understand risk classification and its close tie to insurance prices. The insurance industry clearly has a real challenge if we are to improve understanding of risk classification and its function.

The actuarial profession has also been heavily involved in risk classification issues. The American Academy of Actuaries Risk Classification Committee estimated the financial impact of sex-neutral pricing about three years ago and is now in the process of updating that work. The same committee prepared educational material on risk classification for legislators and is now in the process of finalizing similar material relating to AIDS.

The tremendous potential financial impact of AIDS prompted Lincoln National's underwriting research staff to estimate mortality for a company that does not test for AIDS. The same estimates would apply for a company in a jurisdiction that does not permit testing for AIDS. We looked at mortality in just the next five years. We assumed that seropositive intravenous drug users would not apply for insurance or could be screened out by traditional underwriting methods. We assumed that those already diagnosed with AIDS or ARC could be detected through application questions and perhaps a medical exam. We assumed that 15% of currently seropositive, asymptomatic males would develop AIDS and die in the next five years. Many medical authorities now believe the 15% assumption is too low. Finally, we assumed no antiselection on the part of the seropositive males; in other words, we assumed that if seropositive males account for 2% of the male population, then seropositive males will apply for 2% of the insurance.

We then weighted standard mortality rates by the assumed portion of seronegative males and weighted the estimated mortality for seropositive males according to their incidence in the population. We combined the two to come up with an estimate of total company mortality. At ages 20-29, our calculations showed that mortality would increase about 50%. At ages 30-39, where the percentage of seropositive males is highest, mortality increased almost 100%. At ages 40-49, mortality increased about 25%. In total, a company not testing for AIDS could probably expect its mortality on business written this year to increase 25-75% over pricing assumptions in the next five years, with the exact percentage depending on the age and sex composition of its business. I would emphasize that a lot of assumptions go into the development of an estimate like this, and there are differing opinions on the appropriateness of each assumption we made. The point is that unless the assumptions were far too conservative, and we tried to make the assumptions optimistic, the resulting scenario is devastating. The results seem to say the prices for all insureds would have to

be increased some 50% to cover the additional mortality on the small percentage of the population exposed to the AIDS virus. In this era of thin profit margins, I doubt that any of us, direct writers or reinsurers, are prepared to cover that much additional mortality. One of the concerns we are evaluating is how, if at all, we can continue to do reinsurance business with companies that do not test for AIDS. From what I have been hearing and reading, most companies are taking steps to underwrite for AIDS. Antibody testing is becoming more widely used by life insurance companies, and I predict the testing trend will continue in the future, at least where testing is allowed. Of course, our big concern is that more and more jurisdictions will disallow the use of antibody testing for underwriting.

As I mentioned earlier, the pace of new legislation affecting risk classification has quickened significantly in recent years. The patterns we see in such areas as blindness, unisex and AIDS are likely to continue. Actuaries and underwriters have an important role to play in informing regulators and consumers about the fundamentals of risk selection. We are not the only ones committed to this issue. Today numerous political groups have targeted risk classification as a major discrimination issue. And their efforts are being rewarded. We must counter their programs with a well-reasoned program of our own. We must make an all out effort to influence and help shape the legislation affecting our industry. Once legislation is passed, it is our duty to comply with it. Our challenge today is to make sure the legislation that is passed does not put an end to the risk classification process.

MR. WALTER N. MILLER: Let me start with two postscripts to Mel's remarks. First, the District of Columbia situation is interesting in that a very substantial majority of the companies that were writing life insurance in the district pulled out when this legislation was passed.

The second is one of the more interesting AIDS statistics I have heard in terms of the severity of the threat here. It has been estimated that if you are looking at a group of 30-year-old men who have tested positive, you can expect their mortality to be approximately the same as that of a group of healthy 75-year-olds.

PANEL DISCUSSION

Yield Indexes

The NAIC Yield Index Advisory Committee was started in the middle of 1984 at the behest of the regulatory community; notable among them is John Montgomery. The main thing that triggered their interest in having such an advisory committee formed was what our committee came to call the big red 12% ad. We have all seen lots of them. "Buy the new Extravagance Plus policy with the Miller life -- 12%." And if there is any other text in the ad it is probably not much and certainly little, if any, of the conditions that pertain to the base on which the 12% is credited. The regulatory community started to become concerned about that advertising then. That concern continues because you still see a lot of the ads.

The committee consisted of a wide-ranging group. There were some company people, who took a pretty conservative view of the whole situation relating to whether there should, in fact, be a mandated rate of return index for life insurance, and there were some nonindustry associated members of the committee, who probably started out from a different standpoint.

I think the thing that probably held the committee together was its determination at its very first meeting that it was not going to spend any time at all arguing about whether there should, in fact, be regulation or legislation requiring rate of return disclosure. Instead, we were able to say, "the charge to the committee is not should there be" but "if there were to be a yield index regulation, what form should it take? What should the ground rules be? What should the formulas be?" On that basis the committee, which as I said represented some pretty diverse points of view, operated in a very harmonious fashion. We still had some differences of opinion but the atmosphere throughout was very constructive indeed.

About a year after the committee was formed, it turned in its first report. It was presented at the December NAIC meeting in 1985. That report outlined, with reasons, the studies the committee had made, the discussions it had, and it made some recommendations on the subject.

If there is going to be a yield index regulation what should be involved? I think much of our audience and certainly a number of the committee members

themselves started out this job saying, "This isn't going to be much of a job." Everybody knows the formula to use for yield index is the old reliable Linton yield formula. So, all we have to do is have a couple of meetings, make it look like we studied the situation augustly, and come up with a report saying recommend Linton. That's it.

Boy, did we find a lot below the surface. It turned out to be a very tangled, interesting, challenging, frustrating set of issues. In putting together a regulatory framework for something like this, that supposedly is to have some chance, of operating in the real world, there are a great many trade offs that have to be made from the standpoint of simplicity versus accuracy. The recommendations in the report were rather lengthy because we tried to cover all of the ground. I will mention what to me were the two main ones.

One, as far as the formula is concerned, what do you know -- we did not recommend Linton! We recommended a modification of the Linton yield method that, in terms of the results it produces, is almost identical to Linton. Of the points tested three, four, or five basis points difference at most. So you are now entitled to ask, "Why bother to recommend a modification that produces the same results as the familiar formula?" Our reason was one of philosophy. As I think most of you know, the Linton formula brings in only one cash value. Namely, the one at the end of the measuring period. If you are getting a 20-year Linton yield, the only cash value that comes in is that at the end of 20 years. The formula can accurately be described as the yield that would have to be obtained on the side fund in an alternative buy term and invest the difference scheme that would produce a cash value at the end of the period identical to that of the policy in question. Our committee did not like the idea of endorsing a formula that is philosophically based on the proposition that there is in fact a buy term and invest the difference scheme that is equivalent to a permanent life insurance policy. That is just not true. So the modification that we brought in involves using the cash values of the policy year by year and coming up with a measure of the mortality cost using net amounts at risk reflecting those cash values. It does not produce much difference but philosophically now this formula does not have to be described in terms of an equivalent buy term and invest the difference scheme but rather can be described in terms of the fact that the policy produces two kinds of benefits: a death benefit along the way and a cash

value benefit at the end and a yield on premiums that will produce those benefits and cash value. We were much more comfortable with that.

The other interesting change is that, while every cost comparison formula suggested or in use so far uses either the cash or premium reduction option as an assumption for par policies, we suggested the paid-up addition option. The reason is, you have to use the paid-up addition option if you are going to get any sort of consistency between traditional policies and universal life policies. We thought that was a desirable end.

In 1985, the NAIC accepted our report almost without comment and said, "Now take your recommendations and codify them. Turn them into model regulatory language." We have done that. We submitted the report at last December's NAIC meeting. The action taken then was technically to expose it for a six-month period and presumably at the upcoming NAIC meeting in Chicago at the end of June there will be some sort of action taken by the NAIC. Then approve the report, adopt this model regulation, turn the thing down, send it back to the committee for modification -- who knows?

The one other bit of outside reaction I can report is that the ACLI is going to apparently continue its policy of opposition to any mandatory rate of return index. In the past, that has been based on two primary reasons. One is that research has shown that from a cost comparison standpoint, yield indexes do not produce any significant difference in ranking of policies or companies versus interest adjusted. The second has been a feeling that a rate of return or yield index just draws too much attention to the investment aspect of life insurance and this is not only wrong but can be misleading. I think that feeling is probably stronger than ever today when you consider all of the interesting things that may be taking place on the tax front and related issues. We will see in June whether the continued industry opposition is going to be sufficient to kill the idea of adopting a yield index model regulation.

The committee spent most of its second year not so much on codifying its recommendations but on a question that really was not in our charge -- questions of illustration capability. A lot of us wondered "Why are we standing here worrying about whether to modify the Linton formula when we are talking about a system, that even today, rests on input from company sales illustrations, many

of which are not worth the paper they are printed on?" I think most of us would agree that more and more we are not designing products, we are designing vehicles for illustrations. We are doing some amazing things. Not only are we paying more attention to illustrations and designing our products and how they might actually work in the real world but we are building in some amazing assumptions. We see a bunch of illustrations where the agent is allowed to project improvements in mortality rates and mortality charges. That is really fascinating because not only does that contain the obvious assumption that mortality is going to continue to improve but it also has the implicit assumption that the issuing company down the road is going to change its name to the Magnanimous Life and put every nickel that it gets out of the mortality improvement and pay that right back to the policyowners by reducing their mortality charges and keep none of it for itself. It is an interesting assumption.

The American Academy of Actuaries had a committee working for a number of years to try to develop at least some recommendations that could be used as a basis for setting standards of sound actuarial practice in pricing, repricing and illustrating policies with nonguaranteed pricing elements. What are we talking about? I recently heard someone ask "Is anybody issuing the old style nonpar fully guaranteed cost policies anymore?" Fixed premiums, fixed cash values, no change, that's it. No one in the room either represented a company that was issuing these kinds of policies in any quantity nor had they heard of such a company. That jives with my own feeling that if that is any reflection of the real world, what we are talking about when we say policies with nonguaranteed pricing elements, is we are talking about everything except traditional par. The scope is wide.

The committee is a successor committee to one that came up with standards of practice for traditional par. That committee drew a large circle and said within this circle lie bounds of sound actuarial practice in determining and redetermining dividend scales. We are not trying to say to actuaries that you cannot do anything outside the circle, but we are saying that you should turn in a report to management on your dividend scale determination and if you do anything outside of the circle say so and justify it.

The new committee on the policies with nonguaranteed elements could not even go that far. It tried to in an initial exposure draft and got shouted down by the

response of the membership and finally ended up issuing some recommendations under the auspices of the IASB last fall that say "if you are an actuary responsible for pricing or repricing a policy with nonguaranteed pricing elements, you should accompany this with the report to management detailing what you did." There is no circle. There are many requirements in here for explanation of what practices were followed and why. I think the most important part of these recommendations are the ones that I call "state your game plan." Whenever an actuary advises a company on nonguaranteed charges and benefits, the report presenting such advice should include a description of the company's redetermination policy for the contract classes involved.

What's our game plan? There needs to be a game plan. It could be caveat emptor, it could be the company reserves the right to reprice the policy at any time for any reason in its sole discretion. There is no attempt to bar that practice but it says to the actuary, if you are practicing soundly then say that. It could be bait-and-switch. The game plan could be to initially price the policy below a seemingly self-supportable level to achieve a certain degree of market share at which point the price will be raised to the maximum extent feasible. Once again, there is not an attempt to ban that. Say so. There is a lot in between. That is just an actuary's report to management. It is an internal document and it is possible to say, as far as the impact in the real world, so what?

The American Academy of Actuaries, building on this, made some recommendations to the NAIC Blanks Committee that there be included in the annual statement a set of interrogatories regarding policies with nonguaranteed pricing elements. The NAIC Blanks Task Force approved these recommendations unanimously at a meeting it held on the 17th of March earlier this year. Those proposals need final approval by the parent NAIC committee to that task force. But that approval is expected in June so what we are talking about here, very likely, will be in place with respect to the next annual statement that your company prepares. I will run through these items.

The first one is really important and it says to state your game plan. Define the company's policy to be used in the process of determining nonguaranteed elements with particular reference to the degree of discretion reserved for the

company, together with the general methods and procedures which are expected to be used.

Now the interrogatories -- since last time, have you changed any of your non-guaranteed pricing elements? If so, describe. Indicate the extent to which any of these changes reflect a change in game plan. Are the anticipated experience factors underlying any nonguaranteed elements different from current experience? What this one says is if you are pricing aggressively you ought to say so. Do you use investment generation portfolio average or something in between for classifying investment experience? How do you allocate the experience among various classes? Does the undersigned believe there is a substantial probability that illustrations authorized by the company to be presented on new and existing business can't be supported by currently anticipated experience? If yes, indicate which classes and explain.

I am not going to be presumptuous enough to stand here and say that with the adoption of these recommendations and these annual statement interrogatories the actuarial profession has solved the problem of romantically unsound illustrations and the practices supporting them. I have a strong personal feeling that this is a long step forward in establishing the identity of the actuary as a professional person with some important responsibilities, and that it perhaps puts some tools in the hands of the actuary who is pressured by his management to do some pricing or illustrating on a basis that the actuary considers to be unsound. Hopefully, this will be at least a start in what I think and what Dick Schweiker, the head of the ACLI, has publicly said. It may be the most important problem the industry faces; namely, the forthcoming crisis of confidence in our industry when all of those romantic illustrations start coming home to roost as they will. It will be interesting.

MR. CHARLES A. NICHOLS, III: I have a comment about the slippery slope argument, that is, if we lose the ability to price on the basis of sex we also will lose on age. It seems to me that there is a real difference between the two and that when you are born male or female, except for a sex change operation, you are going to stay that way, so that you will never have the opportunity to purchase insurance as the other sex. But at any given age you would have lived through all of the previous ages and would have had the chance to buy

insurance at a different age. I would like the panel's comments on whether that would seem to be an argument that would stop that slippery slope argument.

MR. MILLER: For openers, I would say that anyone who is a logical thinker would agree in spades with what you just said. Unfortunately, the world of legislation and regulation does not always proceed in a logical manner. I would personally share the concern that if widespread unisex legislation establishes the principle that it is okay to destroy a fundamental logical principle of risk classification for a perceived social purpose, then it is just not impossible for somebody or some group to say, "Well look at the crushing burden that is placed upon the older people of the country having to pay all of those monstrous amounts of dollars for their insurance," and on you go.

MR. MCFALL: I would agree with that line of thinking. I realize there are arguments that would say that you could have unisex and stop there but I am concerned that legislators would not.

MR. DANIEL F. CASE: The point that was just made seems quite obviously true. But I am not sure it is true that everybody who is born passes through every age. Or even any age. One of the arguments that has been made on the unisex question is that sex is a surrogate for other factors such as smoking and other things. If people try to take age away from us they will probably say that age is also a surrogate. To some extent it is. There are some people who are born so severely handicapped that they never pass through what we think of as age 1.

MR. MCFALL: I wonder if that would lead us down the road of biological age underwriting perhaps. There has been some discussion of that where insurance companies would underwrite on a person's biological age as opposed to their chronological age. I think we have a long way to go before we could get to that point, but that might be the road that you are leading us to, Dan, with that kind of thinking.

MR. EDWARD F. COWMAN: Mel, I have a comment that may end up being a question to you. In your remarks, you indicated a fact that is pretty familiar to all of us now, the scenario dealing with the increased mortality and the AIDS situation, with ages 30-39 representing 100% increase. We talked about the

concerns of being able to continue testing or to test at all in some states to the extent that we would like for underwriting. That should be a concern. But I have a concern that even in those areas where we can test and there is an increasing number of reinsurers who are requiring the testing, we are backing into this problem like we have done in so many other areas. Where blood testing typically would be included in medical underwriting, which tends to begin at age 40, it is beyond the real ages of concern and amounts which are extremely high. Any of the studies that you want to do seem to indicate that there is a significant savings to be achieved at very small amounts; certainly smaller than the medical underwriting limits. I am just wondering, are we going to have to back into this whole thing? No one seems to be willing to go after the blood testing at the smaller amounts, where testing would also seem to be justified. I would be interested in the comments of others.

MR. MILLER: Has your company started doing that?

MR. COWMAN: Yes, we are a very small company and nonmedical limits at those significant ages tend to be $100,000. We started out at that, and only because of an outcry from our agency people, "you have to be crazy, no one in the world is testing at those low amounts," we consequently backed off. I am just wondering, is anyone aware of a movement to get to the lower amounts and maybe even under medical requirements going after the blood testing?

MR. MCFALL: I do not think that movement is happening rapidly, but there does seem to be some trend toward lower nonmedical limits which would have been unheard of 2 or 3 years ago. You are right, there is a discrepancy between the typical blood testing limits which are at $200,000, $250,000 or half million and the fact that the blood test is probably protective at amounts of $20,000 or even $10,000 because of the level of mortality that you get if you don't test. There is that discrepancy and I have heard some discussions in other sessions at this meeting about the possibility of dropping blood testing limits below nonmedical limits. I do not know how that would work. It is a problem.

MR. RITZKE: I have one question for Bill. In all of the short-term nonforfeiture proposals that I have seen there are always some elements of rate regulation in interest rates and mortality charges.

Do you see that as a conscious effort by the regulators to introduce rate regulation? And do we have much hope of getting through all of this without having rate regulation on our insurance products?

MR. CARROLL: Chuck, there are two separate questions there. The first question is: Are there elements of rate regulation in these proposals? The answer is yes there are in the short term. I can't tell you the status of the intermediate term right now. It is still within the Academy's committee. The committee will report at the June NAIC meeting.

The regulators (by the regulators in this context I generally mean the state insurance department actuaries, and to some extent the commissioners; it is important that when you hear the word regulators you question who is being referred to) have continuously advocated limitations on mortality charges, requirements as to minimum rates of interest that must be paid, limitations on renewal expenses and limitations on surrender charges. These things were all contained in their short-term nonforfeiture solutions which they developed. They did not recommend it upward to their parent committee. I think the regulators believe some kinds of rate regulation is needed. They do not like to admit to rate regulation. It is very difficult to write a retrospective nonforfeiture law without placing these kinds of limits. A retrospective rule without elements of rate regulation would require the company to credit interest and make charges according to its contract. That is not a regulation from their point of view. They think it is subject to too much manipulation. So, from the regulators' point of view, they want some elements of rate regulation. Historically, industry has strongly opposed it. An important exception is in New York State, where there is a new nonforfeiture law for universal life type products. It contains an alternative retrospective formula with limitations. It has been described as a loose noose because limitations are easy to satisfy. Local insurance industry in New York supported it. The ACLI supported it only with the understanding that there would be an alternative prospective standard available to companies which was similar to the NAIC model.

The second question is: is this coming? I think we can't tell in either the short term or the intermediate term. When the Academy comes out with its proposal, if it has too much in it in the way of rate control it will be soundly criticized by the industry and probably we will begin to hear. "Well we really

should not do this intermediate thing because after all Walt Miller's committee working on the long-range solution will report next summer and we might as well wait for that." Walt Miller's committee is certainly going to have to address the rate control question. It may well be that there has been a change in what people expect from their life insurance. The more we sell our products as retrospective-type products and the more we talk about accumulation, the more perhaps there is a need for a retrospective-type nonforfeiture law which has some of these elements in it. Perhaps Walt will give us a hint on his committee's thinking.

MR. MILLER: In a broad sense, I would say that yes it is coming. To pretend that it might not or that it should not is ostrich like and unrealistic. Let me explain my reason. Jim Hickman, who is a distinguished actuary and also dean of the business school with the University of Wisconsin, wrote a very interesting paper, for the 1986 University of Ohio Actuarial Research Conference to be published in *ARCH* 1987.2, on the history of minimum valuation legislation. In that paper, Jim pointed out that, from an economic standpoint, the concept of setting up minimum standards for reserves and nonforfeiture values can be said to be impediments to the proper functioning in a free market economy. But for social purposes, we, through our elected legislators, have chosen to so impede this effective functioning for the sake of protection of those of us, which are many of us, who buy insurance policies. It comes now to a subjective opinion, but mine is that our society is not going to change its mind on that in the foreseeable future. Now, I think you have to say that almost any form of legislation that specifies minimum standards for either reserves or nonforfeiture values has to carry with it some aspect of rate regulation.

It is interesting that you can even get rate regulation out of legislation (that takes away the need for minimum standards) if you look at Canada. In Canada, it is permissible to issue a whole life policy that does not have any cash values. No cash values, only nonforfeiture benefits are available on lapse. They call it "term-to-100" up there. In pricing this product, it is obviously to some extent, lapse supported and your price for the product will obviously depend significantly on the assumption you make as to the degree of lapsation that is going to occur down the pike. There is a very strong movement afoot in Canada now to strengthen minimum valuation standards and practices to stop what has been perceived as significant abuses and underpricing in this area. The Canadian

Institute of Actuaries has adopted some guidelines in this regard and they may become part of the regulatory framework. Even that is interesting. You say, "Well you don't have to have cash values," but now you have a developing situation where still there is going to be some other regulatory control probably that imposes an effective minimum limit on premium rates.

MR. RICHARD V. MINCK: Rather than a question, I have two historical type observations. One, Walt jarred my mind about some famous actuaries from the past. Alan Mayerson, who was with the New York Department before going to the University of Michigan, and a very distinguished actuary, wrote a paper published by the New York Insurance Department some years ago explaining that the State of New York had rate regulations then. He pointed to the nonforfeiture laws (section 213) which controlled the expenses, both field and home office total, and the requirement in New York law that mutual companies could not accumulate surplus beyond a certain point. He explained that the interaction of those three statutes lead effectively to regulation of rates being charged by the largest domestic companies in New York. Historically, in some aspects we might have had rate regulation if Mr. Mayerson was correct. There is a lot to what he said.

The second historical footnote is back to unisex. The State of Montana (which has the only unisex law currently on the books for life and health insurance) legislature passed laws this session repealing unisex. The governor is considering that the question was lobbied by many people including the governor of Massachusetts who urged that he veto the bill. In fact, he did with the explanation that even though the law resulted in increased costs for many women in the State of Montana (and that was beyond argument) the constitution of Montana required him to veto it. We were four votes short of an override; maybe next year.

MS. CAROL A. MARLER: I would like to know a little bit more about the situation in the District of Columbia. Since so many insurers have withdrawn, is there a perception now that insurance is not available to people in the District?

MR. MCFALL: I am not close enough to it to know for sure but I would think that there would definitely be that perception because you are right, a lot of companies have withdrawn. It was predictable that would probably happen. As

I understand it, some companies even withdrew from Montana because of the unisex legislation.

MS. MARLER: In light of this perception, is there going to be some kind of whiplash to the industry saying that insurance has to be provided in the District of Columbia?

MR. CARROLL: They really cannot force a company to sell a line of business. But they could try to make it a condition for selling other lines of business. Or they can simply apply political pressure. Congress could legally, if it wished, override the District, but home rule is such a big issue that it is not likely. The ACLI supports home rule. We did not as a matter of Council policy ask Congress to override the decision of the D.C. government.

MS. MARLER: I was actually thinking of going the other way, of requiring companies to make insurance available in the District of Columbia. I'm not even sure what type of basis they would have in this situation.

MR. MILLER: It would be a heck of a lawsuit.

MR. CARROLL: I can't believe that any government has any basis to force any company to sell a certain line business.