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ARE CURRENT PRODUCT ILLUSTRATIONS SUPPORTABLE?

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- Do illustrations of either participating business or nonparticipating business with current charges to expenses and insurance and current interest rates provide a basis for an informed decision by the consumer to buy?
  - Are illustrations useful to compare products among companies?
  - What is the purpose of policy illustrations?

MS. PATRICIA L. GUINN: In the last issue of the Product Development Section's newsletter there was an article by David Whittemore entitled "Universal Life Competitive Enhancements #1." Nowhere else would we have a title like that except perhaps in an actuarial newsletter. This article compares the competitive movement in the universal life (UL) marketplace from August 1987 to February 1988. Out of a study of 250 UL products for a particular set, looking at an age 45 nonsmoker, the following conclusions were reached. The product that ranked 20th in August 1987, ranked only 35th in February 1988. It took $54,900 of 20th-year cash value to make the top 10% in August 1987, and in February 1988, it took $56,500, or an increase of $1,600, about 3%. The average product in the top 10% exhibited an increase in 20th-year cash values of about $4,500.

What's happening? Is it higher interest rates, lower cost of insurance rates, higher loads? How are products being illustrated on a more competitive basis? Taking a look at loads, one finds that they haven't changed. The average loads on these top 10% are virtually unchanged from August to February. The credited interest rate is pretty much identical at 9.25%, and cost of insurance rates, instead of decreasing, actually increased a penny or two.

Looking at the median product from the top 10%, where there was an increase in 20th-year cash values of $4,500, it's interesting to look at what was happening at other points in time. In year one, cash values had increased only $15, and in year five only $50. In year ten, it was $500. All of these numbers are around 1-2% of accumulated values. The big number was year 20, $4,500, which was nearly 8% of accumulated values.

If it wasn't a change in cost of insurance rates, lower loads, or higher interest, how are products being made more competitive? What's happening is that the products which are producing the higher illustrated values are more and more products that feature product enhancements. Product enhancements are somewhat like persistency bonuses, but the bonuses are given to policyholders instead of agents. I'll list what some of these might be:

1. Higher future credited interest rates. For example, the product may be illustrated with a 9% current credited rate, and after ten years, if the policyholder persists, the company will add another 50-100 basis points to the credited interest rate.

2. Retroactive interest crediting. If a policyholder persists for five or ten years, we'll recalculate the accumulated value as if we had credited an extra 50 or 100 basis points from issue.

3. There are also noninterest-type persistency bonuses. For example, skipping cost of insurance deductions or declaring zero cost of insurance deductions every fifth year, or returning cost of insurance deductions to policyholders who persist for 10 or 20 years.

These features in certain products have been around for a few years, but it's only been in the last six months that I'd say these features have become more prevalent. These are the product features that are being illustrated by the more competitive products.

MR. PHILIP J. BIELUCH: I would like to start by looking at the history of life insurance illustrations. In the old days, we had a book listing all of the rates and values for the company, at least for 20 years. These rate books were typically cumbersome and expensive to produce, but contained all an agent needed to know about the products. Thank God products lasted five years, because it was awfully expensive to keep redoing them. The agent would get to look up whatever he wanted on the product -- premiums, cash values, dividends, or dividend options, multiply them by a proposed face amount, and present them to the insured.

Insurance companies, recognizing that rate books were too expensive to produce, developed rate cards. These cards provided details of a specific plan for key durations. They were much cheaper to produce and could be folded and put into a pocket.

The typical insurance illustration in the old days was handled on a cocktail napkin over lunch. This napkin contained the company's offer of premiums and benefits and was developed in front of the client by the agent. Napkins had the added advantage that the numbers could be obscured by setting a drink on them.

Home offices then tried to compete with each other on style and developed forms to replace these napkins. The form required certain client information such as the name, age, sex, premium, and cash values to be shown in the appropriate space. It was up to the agent to develop the premiums and cash values and to do the appropriate multiplication. Again, the numbers were under the control of the agent.

After many mistakes by the agent or misrepresentations, I'm not quite sure what, the home offices tried to control the proposals a bit more by requiring the proposals to be developed at the home office or field agency and then be given to the agent. Photocopiers helped the agent gain back some control by allowing him to obscure the parts that he did not like on the originals.

Proposal generation then moved further into the field. This was done, typically, by running a computer line to the agent's office or by time-sharing on a mainframe computer both through home offices or third parties. This was deemed good by the home office because it moved the labor cost of running the proposal to the agent, while leaving the home office in control, since they provided the values to the computer. These systems increased the cost of proposal generation, but moved that cost to the field.

The appearance of personal computers allowed agents to gain further control back from the home office over the actual generation of the proposals. The home office supplied the software, but the agents were responsible for maintaining the latest versions or interest rates in the proposal. If the agent didn't like the latest version, he could use an old version that he liked.

Home office concern developed over how it was going to recall the software when bugs were found or when new products were announced. Also, there were great concerns in the early days over how to force agents to show the actual current interest rates in a declining interest rate environment. Some of the control that the home office had gained since the days of cocktail napkins had been lost.

Ultimate control has now been returned to agents through the availability of spreadsheets. An agent can develop his own formats once again, sometimes based directly on the company's output which can be downloaded into the spreadsheet. He also is able to then manipulate numbers to show exactly what he might want. But now let's look at what has been happening to products during this time.

In the early napkin days, it was simple. Everything was either participating or nonparticipating insurance. Nonparticipating insurance charged a guaranteed premium and gave guaranteed benefits with the insurance company taking the risk that the premiums would be adequate. The client took the risk that the benefits would never be better than proposed.

The other type of insurance was participating. Participating insurance had a higher cost but paid part of this cost back as dividends. Dividend options were developed such as accumulating at interest, which used to be a tax-deferred item, or buying paid-up additions, which was developed once dividends accumulating at interest were taxed. Other options included using these dividends to reduce the premiums, pay up the policy at an earlier point, or buy additional insurance equal to the cash value. The dividend fund in these proposals was treated as we now treat UL-type funds with partial withdrawals available. These partial withdrawals were commonly used to quick-pay the proposals. As agents learned dividend options, there was a need for sophisticated proposals to replace some of the quick numbers that used to be developed.

Nonparticipating insurance recognized that there were competitive disadvantages in selling pure benefits at a guaranteed cost. An early attempt to compete against participating insurance was what was called indeterminate premium whole life. The need for equal disclosure was recognized by the states at that time, and they required the companies to disclose the maximum costs, as well as the current costs, of this whole life insurance. The benefits were always guaranteed, so the only issue was the premium difference, which was easy to show on proposals by a one-liner of the additional costs for the maximum premium on the products.

Universal life ushered in a new era in these proposals because the benefits were not guaranteed, but the premiums were. The proposals typically showed a constant premium and then showed the cash values and death benefits on both current and guaranteed assumptions.

A question that usually came up on these illustrations in the early days, and is still around now, is what interest rate to show. Companies traditionally wanted to show the current rate for all years. When current rates were 12%, companies were unsure of their long-term nature, appropriately so, and tried to show an in-between rate of 8%. The in-between rate had a problem because companies had trouble describing it as a projected rate, an assumed rate, or just the sort of rate that almost gave some credence that this was what actually might happen. It's interesting that these three interest rate proposals showing benefits at a guaranteed, in-between, and current rate are not as popular now that the current rate is down to 8.5%. It's hard to show an interest rate between 8.5% and 4% because of the low benefits provided.

Currently in these proposals, people are projecting interest rate increases into the future. They're also projecting mortality charges. I'm aware of one company that in its corporate-owned life asks what mortality level you want to assume will be prevalent in the future.

Also, in the early days of UL, there was the question of what to illustrate under the guaranteed section of these illustrations. Some companies used to show the current mortality because it was as good as the guaranteed. I think there has definitely been a trend to have the guaranteed section show all of the true policy guarantees and not just the interest rate guarantees.

The early proposal formats for most life insurance showed only the costs and benefits. They ignored interest on the use of money, except possibly in the surrender cost indices which originally were required to be calculated at 4% and then moved to 5%.

All life insurance proposals that you'll find will somehow compare the premiums to the cash values. Some formats do this on a year-by-year basis, showing that the cash values starting in the 10th year actually increase by more than 200% of the premium if the premium is paid. Agents have always been showing the 20th-year cash value compared to the premium to show what a good deal it is.

A significant feature on most proposals in the individual life market is that they ignore tax effects. The taxation of the cash values in excess of the premiums (or basis), or even dividends in excess of premiums, is not a part of selling life insurance through these ledgers.

The conversion of proposal systems to personal computers greatly increased the amount of computer time available to do actuarial-type solving in insurance proposals. Any limitation on the early personal computer storage capabilities was offset by the ability to calculate cash values and dividends from fundamental values. Additional solves available were to pay up a participating policy by cashing in paid-up additions to vanish the premium early or to pay up the same policy by borrowing the premiums plus the after-tax cost of borrowing. Paidups by solving on UL were handled by solving for the premiums to pay up in a given year, solving for the years to pay given a competitor's premium schedule, or solving for the maximum death benefit available for purchase given a premium and years to pay. The ability to change dividend options or to show multiple dividend options on the same policy is now a feature of many illustration systems.

With the microcomputer proposal systems, there is the issue of administration matching the products illustrated. This is from two points of view: one is that the calculations are done to less precision on the microcomputer and the fact that the proposal assumes the policyholder is going to elect certain events in the future. The actual tracking of the administration to effect the proposal as it was proposed is not going on in many companies.

Also, there is a problem that products reflecting the actual interest earnings are usually administered based on daily interest with the exact number of days in a month being calculated for interest crediting. The proposal systems use monthly interest rates based on twelve interest rate periods factoring the annual interest. If the proposal system were to assume daily interest, or in effect that February has only 28 days out of 365, then the actual proposals would vary by month of proposal, just like the values will vary by month of issue. There is a problem where the cost disclosure statement will not match the product as proposed.

Some companies, to gain a competitive advantage, have started doing more advanced proposals. This includes the effects of any borrowings, withdrawals on a UL product, or even borrowings up to the cost basis and withdrawals thereafter. This is done to improve the tax-free nature of the product.

Companies show term compared to whole life or compared to universal. Also, some companies currently show term converted to UL within the same ledger, where the death benefits and costs for three to five years will be the term premiums and afterwards will be UL.

In the early 1980s, there were proposal systems to help facilitate replacements. These are not as popular now that the portfolio average interest rates are greater than new money interest rates.

Universal and single premium policies also develop proposal formats to compare themselves to alternate investments. These include comparisons to money market accounts, annuity products, and municipal bonds. They tend to include the effect of the taxes in reducing the interest rates on the alternate investments, but ignore the tax on the whole life cash value when policies are surrendered.

Insurance sold to corporations provides opportunities to vary the sales format. The most simple form is executive bonus. Here the corporation increases the executive salary by the amount of the premium. The cost to the corporation is based on the maximum corporate tax bracket and is 66% of the premium. The cost to the executive, shown in the maximum personal bracket, is 28% of the premium. Therefore, only 94% of the premium is shown in the worst case, while on a best case sale, the actual executive tax of 28% is shown.

The employee's cost of 28% of the premium is shown against the entire cash value. From the executive perspective, it shows very well. From the combined corporate and executive view, the after-tax cost is 94% of the premium -- 6% of the premium gets lost.

This is a simple sale since there are no tax questions. Basically, this is just another excuse for an increase in an executive salary!

There are also more advanced supplemental pension and deferred compensation proposals. Here the corporation pays money to the executive and pays the premium, and there is a death benefit received by the corporation that magically covers all these costs. These proposals typically assume an age of death, with age 80 popular because it projects a 15-year payout. These are typically done by at least one of the major time-sharing vendors as a special system.

Also, some companies use in these proposals the 1980 CSO life expectancy since this is a "state-approved table." The proposal may randomly assume deaths according to this table. Typically, the agent has the option and insures that the person being proposed to lives for a very long time.

The cost to the corporation may be summarized on a first-year cost in these ledgers so that you can show the extent of the premium going to Mr. Big as a percentage of the total. Showing the outlays for all years or for about 20 years is another option.

Current proposals are moving away from mentioning guarantees. The guarantees that are used to justify the death benefits legally for Section 7702 are typically different than the guarantees discussed by the agent. Certainly, these formats we've discussed, if you see them from a company, will have no mention of the actual product guarantees at all. Typically, you'll find that when they do discuss the guarantees in certain non-par contracts, they're the guarantees that the company may use to justify the death benefit under Section 7702.

There is a trend towards repackaging these proposals by the agent, and, typically, the ultimate buyer is unsure of the home office involvement in generating the proposals.

Some of the third-party systems deal with numbers produced by the company's system and actually reformat them. Some of the companies encourage the agents to buy these systems, since it doesn't require them to maintain all of the advanced underwriting proposals. Within all these proposal systems, the trend is definitely towards the buyer receiving limited disclosure and comfort in what's really in the numbers.

All this leads us back to the age of the cocktail napkin where the proposals are whatever the agent wants to show, only these proposals don't disappear as easily over a drink.

MR. ANTHONY T. SPANO: It's obvious that I was chosen for this panel not because of any special expertise that I might have but to try to achieve some sort of age balance. This meeting is of some personal significance to me since it was exactly 25 years ago this month that I took my last actuarial examination, and I was not one of those who started studying at age two.

The subject we are discussing relates to the broad objective of helping the life insurance consumer make an informed purchase decision. Until a few years ago, industry and regulatory efforts in this regard centered around providing the prospective purchaser with basic narrative and numerical information about life insurance policies. From the regulatory standpoint, these efforts were reflected in the adoption by the NAIC and 3/4 of the states of life insurance cost disclosure regulations. Let me stop at this point and inject an explanatory comment for those of you who may not be familiar with the operation of the NAIC and the significance of its actions.

A major objective of the NAIC is to help achieve uniformity in state regulation through the development of model laws and regulations. These model laws and regulations are merely of an advisory nature, however. By themselves, they do not have any official standing. Each state must take action, and each state is free to ignore a model law or regulation, to adopt it with modifications, or to adopt it as it stands.

As indicated, 3/4 of the states have adopted cost disclosure regulations. These are all based on the NAIC model, in some cases with variations. The regulations require that a *Buyer's Guide* and *Policy Summary* be furnished to prospective purchasers of life insurance. The *Buyer's Guide* provides elementary information about the principal types of life insurance policies and is designed to assist the purchaser in determining how much to purchase, what kind to purchase, and how to compare the relative costs of different policies. The *Policy Summary* provides numerical and other information regarding the premiums and benefits of a policy as well as cost indices that can be used to compare the relative costs of different policies.

These regulations were put into place in the 1970s and early 1980s. Probably little more would have been heard about the subject of consumer information if it weren't for the product revolution in the last several years, and Phil referred to that before. The questions now being debated about consumer information are different from those that were raised when the subject first became alive, many of which related to the types of cost indices that could be used to compare different policies. Today's issues concern primarily the marketing of life insurance products, particularly the nature and credibility of the advertising and sales illustrations for these products.

Efforts to address these issues reached a first milestone at the December 1986 NAIC meeting. There, several regulatory proposals were presented, and some of these have since been adopted. A major one that remains under discussion relates to the regulation of sales illustrations. Let me now sketch some of the background on this issue.

At the June 1986 NAIC meeting, Josephine Driscoll, then the Oregon Insurance Commissioner and President of the NAIC, suggested that revisions to the NAIC model rules on life insurance advertising might be necessary to keep pace with the new generation of products. She proposed was that certain provisions in the model advertising rules relating to policy dividends, including a requirement that illustrated dividends be based on the company's current dividend scale, be extended to apply to all nonguaranteed elements. Her suggestions were incorporated into a set of proposed amendments to the model advertising rules that were exposed at the December, 1986 NAIC meeting.

The only amendment that generated any substantive discussion was the proposed current scale limitation on illustrations. Within the ACLI, comments were solicited from member companies, and the proposal was discussed at committee meetings. Last fall, the ACLI Board of Directors concurred in a recommendation from its committees that the ACLI propose to the NAIC that higher than current scale illustrations be permitted, provided that the fact that they are more favorable be clearly disclosed and that corresponding illustrative figures based on the current scale be also shown. In ratifying this action, however, the ACLI Board indicated it wished to reexamine the issue at its next meeting.

The next event occurred at the December 1987 NAIC meeting, when the NAIC adopted the entire set of proposed amendments to the model advertising rules, including the current scale restriction. At the request of the ACLI, however, the NAIC agreed to give further consideration to the current scale issue at the June, 1988 NAIC meeting.

In preparation for that meeting, the ACLI Board requested that its committees develop a regulatory proposal based on what has become known as the range approach. This approach would require that sales illustrations based on assumptions more favorable than the company's current scale be accompanied by illustrations based on correspondingly less favorable assumptions. Thus, a company that's crediting 8% interest and wishing to illustrate at 10% would have to show corresponding illustrations based on 6%.

The ACLI committees have now developed such a proposal, and it will be considered by the Board at its next meeting on June 1. The proposal includes the following features:

1. The range approach would apply to both life insurance and annuity illustrations.

2. Use of the approach would be elective, not compulsory. It would apply only where a company or agent wishes to illustrate amounts more favorable than those based on the current scale.

3. The approach would be available only with respect to interest rate assumptions. Mortality and expense assumptions more favorable than those based on the company's current scale would not be permitted. A possible extension of the range approach to include mortality assumptions was discussed by the ACLI committee but rejected. The reasons given were that the approach might be too complicated to apply to mortality assumptions, that use of the approach would frequently cause the mortality assumptions on the upward side to reach the level of the policy guarantees, that mortality assumptions don't have as much effect on illustrated amounts as interest rates do, and that mortality rates are more stable than interest rates.

4. The illustrated amounts may be based on interest rates up to two percentage points higher than the current scale rate. Any illustration based on such higher interest rates would have to be accompanied by a similar illustration based on the current scale and a similar illustration based on correspondingly less favorable assumptions. All of these illustrations would have to be shown clearly labeled, in close proximity, and with equal prominence. In no case, however, would a company be required to show illustrations based on lower than the contract guarantees, so if you're guaranteeing 4% and use of the range approach dictates an illustration based on 3.5%, that 3.5% would not have to be shown.

Having described the chronology of events to date, let me just give you the pros and cons of some of the major approaches that have been suggested for controlling sales illustrations. At one end of the spectrum, any illustrations would be permitted subject to appropriate notice regarding their nonguaranteed nature, but there would be no limitation as to interest rates, mortality rates, or anything. This is the situation that prevails today with respect to nonguaranteed elements other than dividends, except in Wisconsin where a regulation adopted in 1982 does prohibit better than current scale illustrations. It is argued by the supporters of a free rein that a free rein on illustrations is necessary to maintain a level playing field between life insurance companies and other financial institutions which are not burdened with these types of restrictions. It is also asserted that there is, after all, nothing magical or permanent about a company's current scale and that illustrations based on other than the company's current scale can provide useful information to the consumer, especially if a change in experience is anticipated.

The principal argument on the other side is that the consumer needs to be protected from outlandish illustrations based on unrealistic assumptions, which can only serve to create consumer dissatisfaction when the illustrated benefits are not realized. Also, it is alleged that, in the absence of any regulatory control over illustrations, the competition between companies and agents becomes a competition not over who has the better product but who can furnish the more aggressive illustrations. It's argued that to the extent that discipline is not exercised by the industry, additional outside regulation may be encouraged.

At the other end of the spectrum would be a prohibition against anything better than current scale. To its proponents, this seems a logical extension of the long-standing practice regarding policy dividends. There is a certain reality to current scales, they argue, since the company is actually providing benefits on this basis. It is charged that if anything better than current scale were permitted to be shown, the agent would tend to emphasize those figures and play down or possibly avoid completely any reference to the less attractive figures. The opponents of a current scale restriction point out that it is difficult to define exactly what current is for this purpose since a company may have a different scale for currently issued business as opposed to existing business. Also, a current scale limitation would favor companies using a new money approach as opposed to a portfolio approach when interest rates are rising. The opposite, of course, would be true when interest rates are declining. It is also pointed out that a current scale limitation would disadvantage companies that may be acting prudently by lowering current rates when the interest rates decline, and also that the current scale illustrations may not be realistic in certain situations, such as at the peak or trough of an interest rate cycle.

Between these two ends of the spectrum, there is an almost endless variety of possibilities, one of which is the range approach. Supporters of this method assert that the range approach would prohibit unreasonable illustrations while at the same time affording companies and agents some flexibility in preparing illustrations. They indicate that it would serve to demonstrate that illustrations are merely examples of how a product will perform instead of being a benchmark of how, specifically, it will perform. There would be an educational value to the consumer, they argue, in that the use of illustrations based on different assumptions would demonstrate the effect on future benefits of changes in assumptions. Other advantages cited are that it might ease pressures to produce aggressive current scale illustrations and that it is more politically viable than a free rein on illustrations.

Some of the opposition to the range approach comes from the proponents of a current scale restriction. They feel that anything more favorable than the current scale simply should not be permitted. Others are concerned that the multiple illustrations that would be required might confuse the consumer. Here we would be requiring current scale, guaranteed scale, two percentage points above, two percentage points below if a company chose to illustrate anything more favorable than the current scale. The opponents also claim that the range figures may perhaps come to be regarded as maximum and minimum figures rather than as merely examples, and also that it might be difficult to apply the approach to policy dividends.

I'll conclude with a word as to the possible next steps in the saga. The ACLI Board will be meeting, as I indicated, on June 1. Whatever regulatory proposal the Board agrees to, and it may or may not involve the range approach, will be presented at the NAIC meeting later in June in the form of an exposure draft. Action on the proposal could then be taken at the subsequent major NAIC meeting which would be in December 1988.

As I indicated, the final disposition of these regulatory issues eventually rests with the individual states. They may or may not follow NAIC recommendations. This freedom of action is a major reason why it is indeed challenging to monitor and to attempt to predict state regulation.

MR. ROBERT C. GREVING: This particular topic, when I was approached to speak on it, kind of hit a chord with me. I'm a product development actuary, pricing actuary, whatever title you want to give to it, and it seems to be a rather sensitive subject on a day-to-day basis for most of us that we have to deal with the issue. My portion of the program deals with our responsibilities as actuaries, and I'd like to visit some topics.

I would first like to bring you back a little bit. All of us can remember vividly those thrilling days of yesteryear when we were studying for actuarial exams, and they were more or less a way of life. Tony's memory may be fading, but he does remember that those were about 25 years ago. For some of us that memory may be all too vivid as the last exam that we encountered was just last week. Some of us may look upon those days as seemingly simpler times when our lives were more structured and better defined.

Just for a moment, place yourself at the examination desk and visualize the question that is facing you: You are the product development actuary for Jungle Life Insurance Company working on a new series of products. Part of your responsibilities include developing the illustration software for use in the field. Your CEO has told you that the company needs a profitable product series in spite of the high unit costs, the expected internal exchanges that will occur to the new series and the impact of FASB 97. Your marketing area has just given you a list of "competitors" and sample illustrations for their hottest products indicating that "we have to meet or beat at least 80% of these companies both in cash value to the consumer and in agent compensation."

What are your alternatives as product actuary? How do you respond to your CEO and marketing officer? Is your response today different than it would have been several years ago? Do your alternatives include aggressive nonguaranteed projections or competitive enhancements in the illustrations? Do your alternatives include unrealistically optimistic assumptions in your pricing models?

The three-legged stool of profit, competition, and compensation has become much more difficult to keep in balance these days. In some cases we are called upon to force the stool into balance with unsupportable pricing assumptions or unsustainable performance projections.

The AAA Guides to Professional Conduct starts off in its preamble with, "Professional conduct involves the actuary's own sense of integrity and professional relationship with those to whom the actuary renders services, with an employer, with other members of the profession and with the world at large." Guide IA goes on to state, "The member will act in a manner to uphold the dignity of the actuarial profession and to fulfill its responsibility to the public."

When we consider the use of unsupportable product illustrations, who are the publics that we're serving? I submit that we have basically six different publics when we deal with this issue: (1) our company, or, if we're consulting actuaries, both our firm and our client company; (2) our agents; (3) the potential policyholder; (4) the regulatory authorities, on an increasing scale of involvement; (5) our profession and industry; and (6) lastly, ourselves.

Our responsibility to our company or our client company is to develop competitive and profitable products. We are looked to by our employers to provide responsible, supportable pricing assumptions. The old adage that we all hear about not having to worry about what happens down the road because we will be retired or have moved on is one that we should not support as actuaries and professionals. We should not be saddling future management with the choice of honoring persistency bonus projections while losing money or, as an alternative, denying these nonguaranteed benefits and thus causing the whole sale from its origin to be a sham. Our company is our source of livelihood, and we should be concerned about the impact that our activities have on it in the present as well as in the future.

Our agents look to us to produce products that provide sufficient compensation to make a living, while not having to worry about whether or not the product gouges the company or the potential policyholder. It has taken awhile, but our agents are finally seeing through our modern products and are beginning to understand the risk that we are passing on to both the policyholder and to the agents themselves. Our agents look to us to develop products that will not be an embarrassment, either today or sometime in the future. We should also be trying to find ways to help our agents return to needs sales rather than ledger sheet sales that we've encountered and replacement selling that has predominated over the last several years. What we do in developing our products reflects directly on our agents.

To our policyholder we are responsible to produce an honest projection of realistic expectations of product performance. It is our responsibility to provide adequate disclosure of both the benefits that are in a policy, as well as the risks that are related to the product that they are buying. They look to us and to their agent for notification of any material change that can affect their insurance program. In many cases, our products are the only savings program that these people have. They rely on our agents who in return look to us for understanding of the products and to advise them of product purchases that are in their best long-term interest. The public has placed in us a trust that we should not treat lightly, for if we betray that trust, it may not ever be restored.

We also have a responsibility to regulate ourselves and to modify our own behavior so that the various regulatory authorities are not compelled to do it for us. Policy disclosures and projections that do not result in complaints or problems with regulators in the future are in our best interest. Regulators look to us to develop product designs that will not jeopardize company solvency in the future. They have a dual concern for both the client and the company and look to us to establish a proper balance between the entities.

As actuaries, we all have a substantial investment in our careers. We have invested our time, our energies and our emotions, which for many of us was a cause of great personal hardship. We are responsible for the continuation of a respected profession in a viable industry. The current price and competition wars affect our companies and the marketplace alike and provide weak spots in our industry which give competitors an opportunity to encroach on our franchise and present a need for further onerous regulations.

We all have personal ethical standards that we use to make decisions in our personal lives. Are we honest with ourselves that our projected pricing assumptions or the illustrations of our products reflect anything resembling reality? How many of you have bought your own products? Can you look yourself in the mirror and feel good about your personal honesty and integrity in this matter? Inner turmoil caused by a conflict with our personal standard of behavior can be the worst that we'll ever deal with. We owe it to ourselves to follow a path that is supported by our personal values and ethics.

A *Wall Street Journal* article, dated March 28, 1988, reported about a couple who purchased a life insurance program and were told that they would only have to pay premiums for a period of five years based upon current interest rates at the time. As a result of a decrease in interest rates since it was originally sold, the couple is now facing the fact that they have to pay premiums for an additional two years to fund the coverage. The insureds have filed a formal complaint with the New York Insurance Department. Both the insurer and the agent, who no longer represents the firm, have told the state insurance department that the insureds were given full disclosure of their coverage's risks. For their part, the policyholders state that they were never once told that the performance of the product was contingent on interest rates. This is a case in which an insurance company apparently simply projected the performance of the product at current interest rates and was not playing any games with tontine-type benefits or "bonus" factors built in to enhance their illustrations. The article in the *Wall Street Journal* occupied about 1/4 of the page with a highlighted box in the center of it which stated, "Many early buyers of the coverage didn't understand that lower interest rates could require them to pay more or accept reduced benefits." The New York Insurance Department examiner in the case stated, "I don't know if we can do anything for these people. It's one person's word against another." In this instance, I would agree that it is one person's word against another, but in my past experience where there is confusion of this nature and claims of misrepresentation, the case is usually resolved on the side of the policyholder.

The harvest that we should expect to reap as a result of our aggressive sales tactics seems to include the following:

1. A general lack of understanding of our products and how they work, what benefits they really provide, and what risks are being absorbed by the policyholder.

2. A loss of confidence and credibility in both the industry and our agents. This is a loss we cannot afford.

3. Agents and policyholders who always want and expect better values, better compensation or both. Actuaries will be asked to "turn that magic wheel" one more time, but all the magic is nearly gone.

4. Regulators concerned for both consumer interests and company solvency. The NAIC, the Federal Trade Commission and even the SEC could be compelled to push for regulatory changes.

5. Disgruntled future policyholders who will introduce persistency problems for our business that we have sold within the past several years.

6. Future claims and possible lawsuits alleging misrepresentation or "bait and switch tactics." The *Wall Street Journal* article may be an early indicator of the whirlwind that we've sown.

How do we react as actuaries and as professionals in the insurance industry? This issue is like a rope -- it cannot be pushed by individuals, but it can be pulled by all of us as professionals. Stand up and be counted in your company, by your agents, by your client company, in industry articles, committees, actuarial clubs, etc. Use your influence to stop unrealistic illustrations and restore integrity to the marketplace. Educate management, marketing and others on the long-term impact on company profitability, image and credibility, potential misrepresentation claims and consumer confidence in our industry. Use positive marketing to gain integrity and image for your company and its products. In the January 18 issue of *The National Underwriter*, there's an advertisement that covers about 2/3 of a page by U.S. Life for its new Medalist Plus series. In that advertisement, U.S. Life states, "Medalist Plus illustrations do not depend on varied mortality improvements, hidden interest increases, or 'pie in the sky' future projections."

What they're basically doing is capitalizing on the fact that they do not rely on all of those things, and they're turning this into a positive for their particular product series. It's almost ironic that in the same issue right next to that particular article, there is another article concerning a new product issue by an insurance company who will remain nameless. In it, the projections in its UL contracts are that the new series of UL contracts are designed for death benefit protection. There is a bonus in it that will pay 45% of the annual premium in UL contracts beginning in the 11th year for the life of the policies. In UL contracts designed for the money purchase and payroll savings market, it will pay 30% of annual premiums for ten years, starting with year 11. And in all of their annuities, it will pay 20% of the premium for the life of the policy from year 11 on.

For many actuaries who are pricing products, designing systems or working as consulting actuaries for client companies, this issue is a true test of integrity and professionalism. It is our responsibility to our publics and to ourselves to restore integrity to our marketplace. It's 1988. Do you know where your proposals are?

MR. GREVING: Tony, are you familiar with and willing to address the issue of the interrogatory that goes along with the convention blank now accompanying Exhibit 8, concerning the actuary's certification as to the supportability of current illustrations.

MR. SPANO: Sure, I'd be glad to comment on that. I don't know how many of you are familiar with those interrogatories. They were put into effect with the 1987 annual statements, and they require that the actuary respond to a number of questions regarding the supportability of illustrations, the company's methods for pricing and repricing products, and whether there has been any change with respect to those items since the last interrogatory was filed. They resulted from a considerable amount of effort by first the SOA and then the AAA. I haven't heard of any particular problems that companies have had in filling out the interrogatories.

I think it would be very interesting if one were a regulator and were to review the responses, to observe the range of responses. And the reason for that is that the interrogatories were framed in some cases in rather unspecific terms. That is, a company would have a fair amount of leeway as to the amount of detail to present or not to present, and I think it would be very interesting to observe what has come out of the companies.

I would like to make one concluding remark: The proposal was adopted really without a considerable amount of opposition. Based on the discussions we had within our organization, I think there really wasn't too much controversy. But, one point that I know bothers some people is that there's a feeling that agents might perhaps make use of information in the responses to these interrogatories in their sales presentations and in some cases that may introduce another element of potential -- and I stress potential -- misrepresentation into the sales process. But, generally speaking these interrogatories, I don't think we have seen any sign of a problem with thus far.

MR. WALTER N. MILLER: I'd like to make one comment on Mr. Greving's presentation, which is, I wish I'd said that! It's a difficult subject, there are a lot of pressures on everybody concerned, particularly the pricing or the product development actuary, and I think you did a super job in putting things in perspective as well as being the only member of the panel so far to address the question that is supposed to be the topic of this session, "Are Current Product Illustrations Supportable?"

I'd like to add a footnote to the annual statement questions. I would agree with Tony that it's quite possible that the answers to these questions are going to be used in competition. There has already been one instance that I know of when they have. This relates to the so-called Schedule M interrogatories which have to do with participating business and were sort of the predecessors of the new ones on policies with nonguaranteed elements. I think all or most of us know that one of the things that has been happening in recent years as new money interest rates have been coming down is that some of the companies that are on a portfolio rate basis for their dividend interest rate have reacted to that by adopting some reductions in dividend scales. In 1986, some of those companies responded to the appropriate interrogatory on the likelihood of continuation of the current dividend scale by saying quite candidly that if new money rates were to keep coming down, they would have to take appropriate action with respect to their dividends which are portfolio rate based. A stock company collected some of those responses and attempted to use them as a competitive weapon against some of those mutuals. I haven't heard any instance where that really did them much good, and the companies that answered the interrogatories that way all had pretty good years in 1987.

I think the fact that responses to these annual statement interrogatories are being used in competition is very healthy and very beneficial. Why not? Why shouldn't agents who are involved in competitive situations first of all be aware of how their own company or the company whose product they are selling answers these questions, answers questions relating to the probability of continuing the current dividend scales, answers questions such as you have in the new interrogatories? Are any of the experience factors underlying current pricing or current illustrations more favorable than current experience? If so, which ones and by how much? Will the continuation of the experience you now anticipate allow you to support the pricing basis you are now illustrating? Agents should know these things. They should know them about the products they're selling, and there's no reason why they shouldn't ask their clients and their customers and their prospects to find them out about an illustration that might be presented in competition. I repeat, I think that's a very healthy thing.

The ASA has just adopted professional practice guidelines for sales illustration disclosure packages which they say should be considered by all their CLU membership, and those guidelines contain very heavy reference to both sets of annual statement questions. It's a development that I think actuaries should welcome as professionals. The actuary plays a very key role, obviously, in how these questions are going to be answered, and it's something that he should constantly be making his management aware of. It's a fact that companies certainly can build in almost anything they want into a lot of illustrations, but there is a professional obligation, and I would claim that there's a need on the part of the companies to disclose. We play a healthy part in this now with the aid of these questions, and I hope we take advantage of it.

MR. GREVING: I think one of Walt's points is well taken in that we can pretty well disclose anything. Tony articulated one of my favorite phrases in his presentation that if we show the guaranteed values in close proximity and with equal prominence, we can illustrate virtually anything on the current side. One of the things that's been somewhat refreshing, at least within the last month for me, was a major marketing firm that we have been affiliated with has approached me with a questionnaire regarding our products and our illustrations, and one of the things that was on it was a question relative to some of Walt's points such as, "Are your current mortality assumptions projected with any improvement in mortality within your illustrations?" I think it's kind of refreshing to know that we are all going to be immortal by the time we reach age 65, but coming from a marketing operation that was a breath of fresh air for me as opposed to, "Here are XYZ Company's illustrations. I don't know what you have to do, but we need to be competitive with that particular product." There are just so many magic wheels and twists that we can put into these things, and there is just so much negative future book profit that actuaries will be willing to sign off on in their products. I don't know about anybody else out there, but I have about reached the end of my rope.

MR. ROBERT E. RICH: I have a couple of related questions for Tony -- one, a point of clarification. Did I understand you correctly to say that in these proposed illustration regulations that using mortality charges that are more favorable than current practice rates would be prohibited, and therefore, projecting future reductions in mortality rates would not be allowed?

MR. SPANO: That's right, Bob. Under the range proposal, the only assumption that could be more favorable than current scale would be the interest assumption. The mortality and expense assumptions would be restricted to be no more favorable than current scale.

MR. RICH: Would that have any effect then on those companies that are projecting that at some future points in time they will refund portions of their deducted cost of insurance rates?

MR. SPANO: The key thing would be what the current scale of the company provides for, and here you do get into some definitional-type problems. I don't mean to avoid your question, but I would say that the answer would depend on the specifics of that company's current scale.

MR. JAMES C. BROOKS, JR.: I would like to also thank the panel, in particular Bob, for stating very well our professional responsibilities and agree with many of Walt Miller's comments. I think we've almost created another C-risk, or maybe a subset of one of the existing C-risks, and that's the risk associated with all of this illustration selling.

Tony, I don't believe I heard this in your remarks. I wonder if you could report briefly on where we stand with respect to regulations requiring disclosure of a true yield rate taking account of expenses, etc., for both annuities and interest-sensitive products, if indeed there is a different position on the two.

MR. SPANO: Okay, I'd be glad to. With respect to annuities, and that's an easier one to answer, the current NAIC model regulation does require disclosure of yield indices. The ACLI supported that position. However, that regulation has not been adopted by very many states. It goes back to the basic point I was mentioning before that adoption by the NAIC of a particular model regulation or model legislation does not have any force or effect in any of the states.

Let me say, if I could just go off very slightly on a tangent here, there is one exception to that, and that's in the annual statement area, and the reason for that is that the laws of the different states require companies to prepare an annual statement in accordance with the latest NAIC requirements. There, if the NAIC acts, the effect is immediate, and that's why these interrogatories that we were talking about before which were adopted by the NAIC very recently are now effective in all states. That is an exception.

I did want to make that clarification but to get back now to your question, the annuity model regulation does require a yield index, but I believe only two or three states have adopted that version of the NAIC model. With respect to life insurance, there is a proposal, and this was one of the December 1986 proposals -- that was really a historic meeting from the standpoint that there were quite a number of proposals that were presented, all relating to this general subject of consumer information. That proposal is still pending and would amend the NAIC model life insurance disclosure regulation to require a yield index. The ACLI opposes that. The ACLI feels that there is a basic difference between life insurance and annuities, and while a yield index might be appropriate for annuities, the ACLI does not feel that it would be appropriate for life insurance. So that proposal is still pending.

MR. MILLER: Just one bit of clarification. The hat I have on now is Chairman of the NAIC Advisory Committee that developed what Tony has characterized as a proposal on yield indexes, and I'd like to say that the charge to the Committee, as we interpreted it, was that if there is ever to be any regulatory requirement of a yield index, what should the regulation look like? What should the formula be, the ground rules, etc.? I'd like to make it very clear that our Committee has not taken a position one way or another on whether there should, in fact, be regulatory requirement of a yield index. It's perhaps a fine line, but a lot of people I know have believed in one way or another that our Committee is proposing that such regulation be adopted, and that's not the case.

It's strictly a question of if there is one, what is the best way that it should be framed.

MR. JAMES J. MURPHY: In the spirit of Mr. Greving's comments, I guess I'm compelled to make a couple of comments about the range idea that Tony described. I am concerned that the approach can aggravate the situation that we discussed in terms of the lawsuit that was described and what people think they've been shown and "promised" in illustrations that they see. I don't necessarily see it solving the current rate or current dividend scale problem as some do. You still need a base from which to set your range. In terms of showing people the variability of values, if the guaranteed rate values are shown with the basis for the values along with the current scale or current rate basis that's being paid on current policies, I think you get the benefit of showing people the variability without showing them higher rates beyond the current rates that might very likely, in an agent's napkin, be shown without the other numbers. I think we should be very concerned, maybe as a profession and perhaps as an industry, that we would be pushing this kind of proposal, particularly when I don't sense that there is similar pressure from field organizations to do such illustrations as there seems to be coming from the companies. It just seems that I would have expected that the proposal would turn up at the National Association of Life Underwriters (NALU), not at the ACLI.

MR. JULE L. GEHRIG: I am responsible for the certifications we are discussing here, and in recent years, I forgot completely to include the certification on the dividends. We are licensed in 31 states. I discovered this two days after we mailed the examination. I immediately drafted a letter that says, "We're sorry you didn't get your copy. It apparently fell out of our envelope in assembly," so that it became a clerical matter when the request came in that someone could put those letters in an envelope and mail them out. We never had to use one copy of either letter which means that 31 states did not get this. None of them questioned the fact that it was not there. I think this generally follows my theory of bureaucracy. The bureaucratic laws are expanding at a greater rate than the bureaucratic people who can enforce them. Those of you who have worked in the pension area with Form 5500s are aware of this. Never once have I had a Form 5500 returned to me with a question on it. The only time that one ever comes back is if one thing is not filled out. No matter how insignificant the question, no matter how obvious the answer, if the blank is not filled out, you get it back. However, no matter how absurd your answer, if it's there, it's accepted. The same applies with these certifications. The same applies with most of what the NAIC is coming out with in regulations, requests, requirements. I think what it boils down to is the way to enforce honesty, if that's the word for proper illustrations, and my company stands firmly on illustrating only what we are currently paying. I believe the only way to enforce honesty -- well, let me retract that. You can't enforce it. It's up to us as individuals to be honest, to show the proper illustrations and to forget about any enforcement from the NAIC. I hope I haven't offended anyone, but that is my nature.

MR. SPANO: I stress again that the NAIC cannot enforce regulations.

MR. GREVING: In light of your response, one thing in getting prepared for this panel that our friend Mr. Tullis, who could not be with us, was doing was a review of the interrogatories for Exhibit 8. At least, he was trying to get that done. He was having difficulty getting a sufficient amount of material. One particular illustration is a company that answered the interrogatory that they didn't have any of those types of policies that applied in the interrogatories. I concur with your observation that it depends upon what the regulators will do with those interrogatories. I guess if I were in a state insurance department and saw something of that nature, a market conduct exam might be in order, but to a great extent, I believe that there are answers to those interrogatories that are going through that are rather absurd. Either there is general misunderstanding of what the interrogatory was trying to get at, although I thought it was relatively clear, or there is actually some dodging going on in the answering. I think from a state regulatory standpoint, there are some states that are very active in market conduct exams, and most of us have been visited by several of them, and that would seem to be an area where they could use a market conduct exam as a means of enforcement. Whether or not they do, I guess time will tell.

MR. JOHN MICHAEL HARRINGTON: We've talked about illustrating at current rates or within a range of current rates. I have a question that I think I'll direct to Phil about how the illustration software can help assure that agents stay within those ranges. With the personal computer software out in the field and the variability of input interest rates, are there are any control techniques that you are aware of that companies are using to make sure that agents don't go above or outside the boundaries that the company would like for them to use?

MS. GUINN: And, in addition, how expensive are these controls?

MR. BIELUCH: There are two sets of them. The simplest one is typically that disks have locks on them with a rate above which you can't illustrate. The new disks going out have a secret switch as to how to change that lock. If the company ever wants to actually allow it to go up, the new version of the software always has a new secret switch. It has the ability to increase rates because you don't want to have to send out a new set of disks just to increase your interest rates.

I have another client that deals primarily in single premium variable where, in order to make sure that the current variable zero coupon trust interest rates are shown, actually has an automatic dial-up to the home office where the software automatically calls up, picks up from the mainframe what the current interest rates are and the dates through which those rates are current, and shows those in the statement of what the zero coupon trusts are yielding currently. So there are sophisticated ways. The cost, I think, if you are doing a home office access is probably $2 to $3 every time you do that, to actually go through the network, get on, sign up, etc., between all your computer charges. The cost of the secret switch certainly isn't much, and that's just in programming up in the front end.

MR. JEFFREY G. STEVENSON: It was pointed out that the purpose of disclosure was to help life insurance consumers make an informed purchase decision. The sales illustration is a key element of this decision. But what is the purpose of a sales illustration? I would submit that there are two extreme views as to the purpose of an illustration. One extreme view is that the illustration is intended to give the customer an indication of how the product will perform down the road with respect to death benefits and cash values, thus providing a basis for differentiating between different uses of savings and protection dollars. The other extreme view is that illustrations should be used to show prospective buyers how the product works, and that they should not be used to create expectations about relative or absolute performance. Now it is important to ask a couple of questions about these two extremes. First, what is the view of the marketplace? I would submit that the view of the marketplace is that illustrations provide an indication of expected performance. If this is the case, then I think most of us would agree that illustrations based on current scale values may be appropriate. The second question: what is the appropriate view? If it is to teach the customer how the product works, different types of sales illustrations might be in order.

MR. BIELUCH: I would like to add just one comment on some of that. When we go out and look at the corporate buyers of life insurance to have them try to analyze some of these illustrations, we try to normalize the request. We request a specific loan interest rate be used and actually request a specific interest rate be used to try to normalize the results. Let me say the agents are very good at not helping us normalize the results. They have their own reasons. One agent was writing for a major mutual company, and the comment is that he can't vary the dividends based upon assumed interest rates. It's only the company's current. Another thing we do is we try to ask that the proposals be signed off by an actuary at the home office, and please if you get any requests to sign off on a proposal, we'd like you to help us out, because we try to trust the proposals, and I think an actuarial sign off certainly helps us in analyzing these to trust the proposals. We are also very unsuccessful at getting actuarial sign offs. I think typically it's more that the proposal hasn't been presented to the home office actuary than that the actuary is unable to sign off on it. In major purchases, we like actuarial sign offs, and we never seem to get them.

MR. GREVING: On an individual sale basis, the use of the illustrations as a sales tool as opposed to a demonstration of the product performance has come about, to a great extent, as part of our replacement mentality that has occurred in recent years. It's the only way that the agents were able to illustrate on a side-by-side basis the value or the projection of existing product or products that were being replaced with the product that they were proposing to replace. It became a problem not just of saying this is what our product does, but also one of how it beats your existing product. Now it has evolved into ledger sheet selling where we have forgotten what the need for life insurance is and what the basic issue that we're trying to sell is. It's become yield and the bottom number on the far right hand side. We've forgotten what else goes on within it and what we're really dealing with. I think that we, as actuaries, can try to find ways to return our agents to need selling. They really do want it. They are struggling with the same issues, I think, and the sooner we can get them back to selling insurance for what it's original purposes were, the sooner we will be able to restore our franchise a little bit.