RECORD OF SOCIETY OF ACTUARIES
1987 VOL. 13 NO. 4B

CONTRACTS WITH NONGUARANTEED CHARGES: IASB RECOMMENDATIONS AND ANNUAL STATEMENT REQUIREMENTS

Moderator: DOUGLAS C. DOLL
Panelists: DOUGLAS C. DOLL
LARRY R. ROBINSON
WILLIAM T. TOZER
Recorder: MARK A. DAVIS

- o Discussion of the Interim Actuarial Standard Board's (IASB) Recommendations, ratified by the Board of Directors of the American Academy of Actuaries and effective January 1987, concerning the redetermination (or determination) of nonguaranteed charges and/or benefits for life insurance and annuity contracts.
  - -- Implications of Recommendations
    - What contracts fall under the Recommendations?
    - What actions do the Recommendations require?
    - Obligations to management
  - -- National Association of Insurance Commissioners Annual Statement
    - Changes effective 1987
    - New interrogatories

MR. DOUGLAS C. DOLL: The main purpose of this session is to talk about the recently adopted recommendations from the IASB concerning products with nonguaranteed elements, and also about some related annual statement changes that have been made that also concern themselves with nonguaranteed elements. I am going to moderate and be the first panelist. Our other two panelists are Bill Tozer and Larry Robinson.

Mr. Tozer is senior vice president of Kentucky Central in Lexington. Bill is chairman of the Academy committee that originally drafted the recommendations.

These nonguaranteed element recommendations were initially drafted by Bill's committee and then ultimately were promulgated by the IASB. Bill is also a member of the life committee of the IASB.

Mr. Robinson is executive vice president of State Life in Indianapolis. He is chairman of the ACLI's Cost Comparison Subcommittee. These recommendations and the annual statement changes fit in with what's going on on a broader level regarding disclosure and cost comparison.

Part of the notoriety of the recommendations concerning nonguaranteed elements is that they are the first recommendations promulgated by the Interim Actuarial Standards Board (IASB). It may be useful to describe just what the IASB is.

The IASB was created in 1985. Its purpose is to develop and update actuarial standards of practice on a comprehensive basis. The IASB was created by the American Academy of Actuaries Board of Directors. The IASB Board members are nominated by the Council of Presidents. (The Council of Presidents consists of the president and president-elect of the four major U.S. actuarial organizations.) Confirmation of IASB Board members and approval of the IASB recommendations must be made by the Academy Board.

If the IASB serves its purpose, it will eventually be replaced by the Actuarial Standards Board (ASB). There is a separate committee, called the Standards Organizing Committee, that is working on developing the ASB. A proposal for this will be mailed soon to Academy members. It is anticipated that it will be created in mid-1988 if the Academy membership approves. Probably, the ASB members will continue to be selected by the Council of Presidents. The Academy Board's authority would be removed, although the ASB would remain an Academy entity for purposes of finance and administration.

What is the IASB role in determining actuarial standards? According to the Academy, generally accepted actuarial principles and practices emerge from utilization and adaptation of concepts described in actuarial literature. Such actuarial literature includes, but is not limited to, the Academy's recommendations and interpretations. The Academy's guides to professional conduct indicate that an actuary must take recommendations and interpretations into consideration or be able to justify why not. It is the IASB's role to address these recommendations and interpretations.

Prior to the IASB, the Academy had developed recommendations in three areas: financial reporting, pension planning, and dividends. The IASB has promulgated three sets of recommendations. A set of recommendations on nonguaranteed elements was promulgated in January, 1987. Two other sets of recommendations have been promulgated, one on continuing care retirement communities and one on actuarial communications related to FAS 87 and FAS 88.

The IASB consists of a Board with nine members and five committees. The committees are: casualty, health, life, pension, and specialty. The specialty committee handles everything not covered by the other four committees. For example, the continuing care retirement communities recommendations came under the authority of the specialty committee. Note that these committees might delegate work to other Academy committees.

There are several committees formed for the express purpose of promulgating recommendations. In order to justify their existence, we can expect several sets of recommendations to be proposed. In fact, according to the monthly status report of the IASB agenda that accompanies the Academy newsletter, there are six sets of recommendations for which we can expect at least an exposure draft by the end of this year. All of this is a part of the Academy's desire to become more proactive than reactive in setting actuarial standards.

MR. WILLIAM T. TOZER: For decades, policyholder dividends were a noncontroversial item. This changed, however, when the investment generation method of crediting interest appeared on the scene. As a result, the Society of Actuaries appointed a committee to study the use of the investment generation method in the determination of dividends.

This committee prepared a report that stated policyholder dividends are generally based upon the contribution principle. In addition, the report discussed methods of including investment income in the contribution principle including the investment generation method. The Society's report was adopted by the Board of the Society of Actuaries and forwarded to the American Academy of Actuaries.

The Academy of Actuaries appointed a committee that took the Society report and developed it into a set of twenty recommendations. These recommendations covered not only dividend determination but also dividend illustrations for individual life insurance issued by mutual insurance companies. These recommendations were adopted by the Board of Directors of the American Academy in October, 1980 and became Generally Accepted Actuarial Principles.

The Academy committee also prepared a set of Interrogatories that were recommended to the National Association of Insurance Commissioners for attachment to Schedule M of the Convention Blank. These recommendations also proposed an actuarial opinion on dividends be included with the Interrogatories. The NAIC adopted the Academy's recommendations and mutual life insurance companies have been required to attach the answers to these Interrogatories.

Since the Society's report only covered dividends issued on individual life insurance policies issued by mutual insurance companies, the Society committee felt that their report was incomplete. As a result, they modified their report to include dividends on individual life insurance issued by all life insurance companies, including stock life insurance companies. This required modifications to cover the relationship between policyholders and stockholders. In addition, since the development of the initial report, annuities had become a major premium producer for many companies. As a result, the Society committee also modified the report to cover participating annuity contracts.

The Society committee, on completing the report, sent it to the Academy committee on dividends. The Academy committee modified their twenty recommendations to incorporate the suggestions in the Society report and also increased the number of recommendations to twenty-three. They also developed three dividend interpretations to help clarify the recommendations. The Academy Board adopted the recommendations in November, 1985. These recommendations apply to dividends illustrated or distributed after December 31, 1987.

The Academy dividend committee made a set of recommendations to the NAIC to change the Interrogatories and Actuarial Opinion on Dividends. Those changes have been adopted by the NAIC.

CONTRACTS WITH NONGUARANTEED CHARGES

While the Society committee was working on dividends paid on life insurance sold by stock life insurance companies, they were approached by a staff member of a large state insurance department. That staff member requested the committee include in their report indeterminate premium products. The committee decided to complete the project on dividends before considering indeterminate premium products. As a result, the Society committee has now turned to indeterminate premium products.

It was decided early that this project should be expanded to include all nonguaranteed pricing elements except dividends and not be limited to indeterminate premium products. By this time, universal life had become an important product in the marketplace. The Society committee developed a report for nonguaranteed elements based upon a concept called the Continuity Principle. The report was really a version of the dividend report. This report was exposed to members of the profession in the form of an exposure draft and an open forum was held at Society meetings in Washington, D.C. and Hollywood, Florida. The response received from the membership was very negative. As a result, the Society committee abandoned the Continuity Principle and developed a completely new approach.

The foundation of the new approach was an actuarial report and extensive communication. An exposure draft of this approach was sent to members of the Society. The exposure draft was well received. As a result, the report was forwarded to the American Academy committee on dividends. This committee prepared a series of eleven recommendations and one interpretation based on the Society report. While the committee was working on their project, the Interim Actuarial Standards Board was established and the committee was made a subcommittee of the IASB.

In March, 1986, an exposure draft was released by the Standards Board to the members of the American Academy of Actuaries. Comments were received and modification made by the subcommittee. A final draft was prepared and in the fall of 1986, the Interim Actuarial Standards Board adopted the recommendations. Since the IASB is operating at the present time under the American Academy of Actuaries, the IASB's adoption was forwarded to the Board of the Academy of Actuaries which adopted the recommendations in December of 1986. As a result, these Recommendations on Nonguaranteed Elements are now Generally Accepted Actuarial Principles.

As part of the exposure process, the subcommittee held an open forum on their exposure draft at the Society meeting in Boston. The main reaction of the members at that open forum was that the recommendations would have limited value unless the NAIC and buying public was given additional information. The subcommittee shared these same thoughts. As a result, the subcommittee, acting as an Academy Task Force, prepared three proposals to be presented to the NAIC.

The first proposal was a recommended set of Interrogatories on Nonguaranteed Elements to be attached to the Convention Blank. These Interrogatories are similar to the Dividend Interrogatories and also include an Actuarial Opinion on Nonguaranteed Elements. These recommendations were presented to the NAIC Blanks committee at the December, 1986 meeting of the NAIC. The Blanks committee asked for minor modifications which were made and presented to the Blanks committee at their meeting in March, 1987. The Blanks committee adopted the recommendations and they are now part of the Instructions to the Preparation of the Convention Blank for the year ending 1987.

The second and third set of proposals to the NAIC were modifications to the Life Insurance Advertising Regulation and the Life Cost Disclosure Regulation. These proposals were presented to the NAIC at their December, 1986 meeting. The NAIC exposed the proposals for comment and possible adoption at the June, 1987 meeting. The American Council of Life Insurance argued at the June meeting for postponement of adoption until December, 1987. They requested time to offer suggestions for improved wording of the Academy's proposals. The NAIC deferred action until December.

The ACLI has reviewed the language of the Academy proposals and it appears it will recommend some changes in December. At this time, it appears the changes are acceptable to the task force. As a result, I would expect the NAIC will adopt the changes in both the Cost Disclosure Regulation and the Advertising Regulation in December, 1987.

CONTRACTS WITH NONGUARANTEED CHARGES

MR. DOLL: We have given you a little bit of the background about the IASB and the history of these recommendations and the annual statement changes. What we are going to do now is talk awhile as to what the specifics are on these recommendations and changes and what impact they're going to have. The Academy has felt that the publicizing of these new recommendations is very important and, in fact, has set up a special task force specifically to publicize these new recommendations. The chairperson is Mr. Larry Edris from Lincoln National. The purpose of the task force is twofold: (1) to let us actuaries know what our responsibilities are from these new recommendations, and (2) let insurance company management know what they should expect from their actuaries in the areas covered by these new recommendations.

I'd like to cover three scenarios that those of you who are involved in product development might be able to find some sympathy with. These scenarios were developed by Mark Tullis.

- Scenario 1. You are the actuary for a life insurance company. The chief marketing officer calls you on the telephone and asks you to estimate the increase in premium that would be necessary if first-year commissions for the company's indeterminate premium product were raised by 20%. He wants the answer over the phone, and he wants it fast.

- Scenario 2. You are the actuary of an aggressive stock life insurance company. The chief executive officer has asked you to develop rates for a new excess interest whole life product using marginal expenses and using a breakeven profit objective. You feel uncomfortable doing this, since you feel that neither the stated expense assumption nor the profit goal are in this particular company's best interest.

- Scenario 3. As actuary of a life company, it is your responsibility to sign the statement of actuarial opinion in the company's annual statement. The company has developed a universal life product assuming an interest spread that increases by duration, although the product is typically illustrated using level current interest. Furthermore, the company has assumed future mortality improvement in its pricing of the product. For 1987, you must now sign the newly required statement of actuarial opinion for products with nonguaranteed elements and you must also answer the associated interrogatories for this universal life product. The company does not want its pricing assumptions made public through your answers to these interrogatories.

Those are the three scenarios that I want you to consider -- I will return to them shortly. The job of being an actuary has become increasingly complex in recent years. The life insurance product revolution and the change from years of relatively level interest rates to an environment of wildly fluctuating economic conditions have each placed unprecedented technical requirements upon the profession. However, little attention has been given to the increased professional responsibilities which have also been placed upon the profession in recent years.

Of particular consequence are the Interim Actuarial Standard Board's recommendations concerning the redetermination of nonguaranteed elements for life insurance and annuity contracts. Of equal importance are the changes to the annual statement adopted this year by the NAIC and effective for life companies' 1987 annual statements, which require an actuarial opinion to be signed by an Academy member as to the actuarial assumptions and methods used to determine nonguaranteed elements for individual life and annuity policies and which also require a series of eight interrogatories to be answered that address certain company procedures with respect to the determination of these nonguaranteed elements. These two items, the IASB recommendations and the changes to the annual statement, have direct bearing on the three scenarios that I've described.

The IASB's recommendations are currently effective. They are concerned with the "redetermination or determination of nonguaranteed elements" of life insurance and annuity contracts. The recommendations apply when an actuary determines any of the following: (1) cost of insurance rates, nonguaranteed expense charges and interest crediting methodology for universal life and excess interest whole life products; (2) premium rates for indeterminate premium and excess interest whole life products; (3) rates or values for nonguaranteed single premium whole life and single premium deferred annuity contracts and all other nonguaranteed premiums, nonguaranteed elements, and nonguaranteed benefits of life insurance and annuity contracts.

The recommendations apply when the actuary prices these items for new products as well as when he reprices business already on the books. If an actuary were to recalculate cost of insurance rates for an in-force block of business, the recommendations would apply just as if he were pricing the product originally. You should note, however, that they do not apply when interest rates change for a product, but only when the interest crediting methodology changes. If the product is priced with a certain interest spread and if methodology is set up to try to achieve that spread, the actuary would not have an obligation as rates fluctuate on a monthly basis, but would have an obligation under these recommendations if either the target spread were altered or if the methodology determined by the company to achieve the spread were altered.

The recommendations state that:

1. The actuary should provide a written report to management whenever advising an insurance company on nonguaranteed charges or benefits. This applies to both consulting and company actuaries.

2. The report should include a description of the framework within which his advice has been developed as well as a description of the facts, methods, procedures and assumptions used.

3. The report should address a number of items, including sensitivity tests and a discussion of any applicable regulatory requirements.

4. The recommendations also state that it is the actuary's responsibility to help management understand the financial consequences of pricing decisions. It is management's responsibility to determine the policy used by the company in determining nonguaranteed charges and benefits, as well as the solvency margin, marketing objective and profit goals. This item is of particular consequence to actuaries. It is our duty as professional actuaries to inform management as to consequences of decisions, but as we are not ourselves company management, it is not our responsibility to make policy decisions.

One could argue that the recommendations amount to good business sense -- they describe the sort of conduct which actuaries should follow anyway.

Nevertheless, it's surprising how often that company management is unable to find any documentation for the pricing of a product, or if the documentation does exist, it consists of cryptic computer output which is understandable only to the actuaries who actually run the program. To me, this points to the need for general professional standards such as those contained in the recommendations -- and for the acceptance of and adherence to the recommendations by the profession at large.

The new statement of actuarial opinion relative to nonguaranteed elements was adopted by the NAIC this summer and is required to be included in the 1987 annual statement for companies that sell products with nonguaranteed elements. The opinion requires the actuary to sign that "I have examined the actuarial assumptions and methods used in determining nonguaranteed elements for the individual life insurance and annuity policies of the company used for delivery in the United States . . . . In my opinion, the nonguaranteed elements described above have been determined in accordance with generally accepted actuarial principles and practices applicable to the determination of nonguaranteed elements, except as described above."

The reference "described above" refers to the eight newly added Interrogatories. These Interrogatories ask such things as whether there have been any changes in the values of nonguaranteed elements, whether there have been any changes in the general methods and procedures last reported, whether the company uses a portfolio or investment generation approach, and how the company allocates anticipated experience among its various classes of business. However, to me the most significant of the Interrogatories are #4 and #7 which ask respectively, "Are the anticipated experience factors underlying any nonguaranteed elements different from current experience? If yes, describe in general terms the ways in which future experience is anticipated to differ from current experience and the nonguaranteed element factors which are affected by such anticipation." And #7 asks, "Does the undersigned believe there is a substantial probability that illustrations authorized by the company to be presented on new and existing business cannot be supported by currently anticipated experience? If yes, indicate which classes and explain."

How do these statements and interrogatories affect actuaries? First, they require that the actuary who signs the statement of actuarial opinion be familiar with the illustration methodology used by his company. That may seem obvious, but it does not always exist.

However, and perhaps more importantly, consider the following pricing strategies and think about how your answers to the interrogatories might be affected:

- Pricing based on marginal expense assumptions. A number of companies have priced universal life products assuming expenses lower than actually experienced for this line of business under the rationale that it is a new and growing line of business and it is not reasonable to expect the volume to be up to the level necessary in order to pay for the expensive administration system required. If marginal expenses were used in pricing, it is literally true that the underlying nonguaranteed expense elements are different from current experience. Would it then be necessary to disclose in the annual statement or in an attachment to the annual statement that marginal pricing was used?

- Mortality improvement assumed in pricing. For a company which assumed mortality improvement in pricing, say, its indeterminate premium product, it is true that anticipated experience factors underlying nonguaranteed elements are different from current experience. Again, would it be necessary for the company to disclose that it assumed mortality improvement in pricing the product?

- Companies which price assuming an increasing interest spread on their universal life product or, alternatively, companies which price with a level spread, but which are current crediting interest rates which do not enable them to earn this level spread. In the first case, if the company is providing illustrations on a level crediting basis, what would the answer be to the question, "Is there a substantial probability that illustrations authorized by the company to present on new and existing business, cannot be supported by currently anticipated experience?" In the second case, again what is the answer to the question, "Are the anticipated experience factors underlying nonguaranteed interest elements different from current experience?"

Presumably in all of these cases, it will be necessary for the actuary to disclose a key element of pricing strategy in the answers to the interrogatories.

Because these recommendations are so new and because the changes to the annual statements have not actually been put into effect by any companies, it's impossible to say what effect they will have on product design and to what extent disclosure will actually be realized in the 1987 statement blank. My guess is that in practice the answer to these questions will vary quite a bit from company to company as both the recommendations and the interrogatories are worded broadly enough as to allow multiple interpretations.

However, let us again consider the three scenarios that I gave you at the beginning of my talk:

- <u>Scenario 1</u>. The chief marketing officer requests a ballpark estimation of the effect on premiums for a product if commissions are raised by 20%. He wants the question answered quickly over the phone. Clearly, you may give him an oral response, but you should follow up with a written report, making clear what assumptions were used to derive the answer. It's not necessary that the report be a huge, bound tome incorporating all actuarial knowledge, but it should address the basic elements required under the Academy recommendations.

- <u>Scenario 2</u>. Your chief executive officer client requests a product to be developed using marginal expenses and with a breakeven profit objective. You do not feel that the expense assumption or profit goal are in the best interest of the company. Your responsibility is to help management understand the consequences of business decisions. You should provide your client with the requested rates, but should also, in the report, indicate the anticipated consequences of adopting them, including consequences such as how they would affect the answers to the new Interrogatories in the annual statement blank.

- <u>Scenario 3</u>. Your client has a universal life product with a number of items which may affect the Interrogatories required in the 1987 Annual Statement, but your client does not want you to divulge pricing information in your answers to them. As a member of the Academy, it is your

> responsibility to answer the questions in a manner that is consistent with the Academy's guides to professional conduct and the Academy's recommendation concerning the nondetermination and redetermination of nonguaranteed elements. Based upon your study of the particular client situation and practices, you have a professional obligation to answer these interrogatories in a way that you see fit consistent with these items.

Clearly, the new recommendations and the annual statement changes are going to have an effect on the way product actuaries conduct their business.

MR. LARRY R. ROBINSON: I'm not on this panel as a technical expert for the IASB standards for nonguaranteed elements. Mr. Tozer and Mr. Doll can provide that expertise. Rather, I bring the perspective of currently serving as Chairman of the ACLI Cost Comparisons Subcommittee. Our group is faced with balancing interests of companies, regulations and consumerists in many issues arising from nonguaranteed elements in life and annuity products.

I want to talk with you about the principal industry issue which has led to our topic, take a brief look backward as to the origin of the issue, and then discuss some of the responses being undertaken by the ACLI and our actuarial profession.

CREDIBILITY -- A PRESSING INDUSTRY ISSUE

Take a poll of chief executive officers (as LOMA recently did) and you find that the greatest issues facing our industry are profitability followed closely by credibility. Take a poll of consumerists (as perusing any of several industry publications will show) and you find that the greatest issue facing our industry is credibility. Jack Bobo, executive vice president of the NALU, captured the credibility issue quite well when he said at last month's Orlando meeting: "The freedom to illustrate future policy benefits without realistic restraint will surely produce chaos in the form of lost public confidence and credibility," and "The current overemphasis on investment results puts us on a collision course with other intermediaries and our policyholders' expectations. If we cannot find a way to put limits on our freedom to illustrate anything we can imagine then surely there is someone who will do it for us."

It's helpful to take a look at our industry credibility and how it worked before. Our industry has been built upon more than 100 years of providing guarantees and quasi-guarantees for life insurance and annuity products. Nonparticipating life and annuity contracts symbolized the ultimate in guaranteed financial instruments: fixed premiums provided fixed guaranteed benefits.

Participating coverages, due to generally rising interest rates, lowered mortality experience, and expense reductions through computerization caused dividends to generally exceed those illustrated at issue; dividends thus became, in the eyes of most policyholders and agents, quasi-guarantees. So, until recently, policyholder expectations, with few exceptions, were met or exceeded on their life and annuity products.

What has changed after years of interest rates generally going steadily upward is that we have *discovered* the fact that rates can come down as well. No longer can policyholders expect that benefits illustrated to them at issue will be equaled or exceeded. Obviously, the list of the adverse policyholder effects arising from decreasing interest rates is extensive; e.g., policies sold on the basis of "disappearing premiums" may in fact require considerably more premiums to retain coverage than illustrated at issue.

The drop in prevailing market interest rates has not been paralleled by commensurate drops in "current scale" rates of most companies. In part, this can be attributed to the portfolio basis for interest rate determination; there is considerable evidence to suggest, however, that current rates on interest-sensitive products are being subsidized, i.e., rates paid exceed those required (earned less necessary expense margins). So not only are rates paid lower than illustrated for recent years' issues, but the "true" rates may be even lower yet!

The topic of life insurance industry credibility is beginning to receive increased media scrutiny. Two recent examples: The January 1987 issue of *The Insurance Forum* leads off with an article entitled, "Are Life Insurance Sales Illustrations Out of Control?" The March 1987 lead article for *Probe* discussed "Life Insurance and the Public's Confidence." Consumerists and regulators, as well as the companies themselves, are asking what can be done about the situation.

CONTRACTS WITH NONGUARANTEED CHARGES

One response from agents to the declining interest rate environment is to illustrate policy performance under even lower interest rates than those being paid; this has been endorsed and encouraged by companies. This is part of the necessary policyholder education of the basic fact that interest-sensitive means that rates can and do move up and down. In addition to policyholders' understanding of the "rules of the game," there has to be an underlying basis for interest rates and other nonguaranteed elements which provides for fair and equitable treatment of policyholders.

The ultimate solution for reestablishment of credibility will in large part lie with the insurance companies themselves. Our general industry preference toward self-policing has placed great emphasis on public disclosure as opposed to restrictive regulation. Both of these elements, self-policing and disclosure, are present in the two developments referenced earlier in this panel discussion.

In addition to the two major responses previously discussed by Mr. Tozer and Mr. Doll on the IASB recommendations and new annual statement interrogatories, there are three related proposals which have been endorsed by the ACLI Cost Comparisons Subcommittee:

1. Advertising. As indicated in ACLI General Bulletin 3826, the ACLI has recommended to the NAIC that: "The NAIC model rules governing the advertising of life insurance should be amended to require certain narrative disclosure in any advertisement that shows a specific interest rate credited on premiums or cash values. Also, the model advertising rules should be amended, as proposed by the American Academy of Actuaries Task Force on nonguaranteed elements, to prohibit nonguaranteed elements from being presented in a misleading manner, and to require that illustrations or statements involving nonguaranteed elements be accompanied with equal prominence by comparable illustrations or statements involving the guaranteed elements."

2. Control of Benefit Illustrations. Different recommendations for controlling benefit illustrations had been presented at the December, 1986 NAIC meeting. The American Academy of Actuaries' Task Force on Nonguaranteed Elements and the NAIC Market Conduct Surveillance task force both proposed prohibiting the illustration of benefits greater than those based on

the company's current rate scale. The NAIC Yield Index Advisory committee, however, recommended that such benefit illustrations be permitted, provided they are accompanied by an appropriate statement.

Our ACLI subcommittee recommended that the ACLI propose to the NAIC a requirement that, if benefits greater than those based on current scale are illustrated, the fact that they are more favorable be clearly disclosed and corresponding figures based on the current scale be also shown in the illustration.

3. Disclosure of Company Practices Regarding Changes in Nonguaranteed Elements. The ACLI will be recommending to the NAIC that advertisements, illustrations, and the policy summaries involving nonguaranteed elements contain a statement that the insurer reserves the right to change any such element at any time and for any reason. However, if an insurer has agreed to limit this right in any way, such as, for example, if it has agreed to change these elements only at certain intervals or only if there is a change in the insurer's current or anticipated experience, the statement may indicate any such limitation on the insurer's right. Existing policyholders would be notified in the event of a change in the insurer's policy.

As I hope has been evident from my remarks, our industry is faced with very significant problems in connection with the long-term credibility of contracts involving nonguaranteed elements. As actuaries, we now have an opportunity and an obligation to be an important part of the solution to these problems.

MR. DOLL: Mr. Tozer mentioned earlier, when he was talking about the first draft of the recommendations on nonguaranteed elements, that it was very much consistent with the recommendations for determining dividends on par policies, and that it received a howl of protest when exposed and subsequently the recommendations were changed to what we have now. However, when you read the recommendations for nonguaranteed elements, you find that there's a lot of similarities in what the recommendations for nonguaranteed elements describe and what the dividend recommendations describe. Bill will talk a little bit further about how these recommendations differ from the dividend recommendations and exactly what the nonguaranteed element recommendations require.

CONTRACTS WITH NONGUARANTEED CHARGES

MR. TOZER: I was on a panel on this same topic earlier this month at the annual meeting of the Conference of Actuaries in Public Practice. One of my copanelists was Chris DesRochers. Chris made a fine presentation comparing the recommendations on dividend practice with those on nonguaranteed elements, and I would like to share that information with you. The recommendations on nonguaranteed elements are requiring us to do some things that we have not been doing in the past. You may worry that these are going to require excess disclosure of what the company is trying to do and disclose proprietary information. I don't think you're going to find a greater threat for the nonguaranteed element recommendation interrogatories than is the situation for products with dividends. I think that most dividend actuaries have found that they can work in this environment without too much problem.

Conceptually, if we compare dividends to nonguaranteed elements in individual life insurance policies, we can see that there are both striking similarities and significant differences. The tax code, for example, sees very little differentiation, and treats both indeterminate and participating products identically for purposes of determining corporate federal income taxation. Thus, under the Internal Revenue Code, the definition of dividends includes both traditional participating dividends as well as the so-called phantom dividends which are found under indeterminate premium policies.

At the same time, however, we in the actuarial profession draw some clear distinctions, both in terms of the pricing philosophies and actuarial responsibilities. While the actuarial responsibilities differ, the method and techniques applied are consistent given the different natures of the products. I will address the similarities and differences in the two sets of recommendations by specifically addressing those recommendations on nonguaranteed elements with appropriate comparisons to dividend recommendations. As a consequence, I will cover more of the nonguaranteed elements than I will with the dividend recommendations. My comments on the recommendations also apply to the interrogatories required by the NAIC Annual Statement.

The recommendations on nonguaranteed elements apply to both the determination and redetermination of nonguaranteed charges and benefits. These recommendations apply generally to contracts under which the charges or benefits may vary at the discretion of the insurance company. The dividend recommendations apply to dividends illustrated or distributed under the provisions of participating plans, whether these are issued by mutual companies, stock life insurance companies, or fraternal benefit societies.

In the same way that the recommendations on nonguaranteed elements address both the initial determination and subsequent redetermination of these elements, the dividend recommendations address both the determination of currently payable dividends and illustrated future dividends for both in-force policies and new business. Note that it is possible for both sets of recommendations to apply to a single policy form in the event that a participating indeterminate premium plan were written and, in fact, some of these products do exist.

In terms of the actuarial standards articulated, both the dividend recommendations and those on nonguaranteed elements are similar in that they require a formal actuarial report to be written for the client, which documents the advice given, either in the determination of the dividend scale, or in the determination of nonguaranteed elements. The fundamental responsibility of the actuary under either set of recommendations is quite different, however.

The recommendations on nonguaranteed elements can be said to be documentary in nature, in that the actuary is required to "assure the completion of all activities required to advise the client professionally." By comparison, the dividend recommendations are methodological in nature, in that the fundamental responsibility of the actuary is to apply the contribution principle in the determination of dividends. Or, if the contribution principle is not used, to explicitly state in the actuarial report the deviation from that principle, and the rationale underlying the use of the different method. Thus, the actuarial responsibilities set forth in a dividend recommendation are met if the dividend scale is demonstrated to be consistent with the contribution principle, while those of the nonguaranteed element recommendations are met if all the document requirements are fulfilled.

The rationale for this differentiation can be found in the Society of Actuaries' "Report of the Committee on the Theory of Dividends and Nonguaranteed Elements in Life Insurance and Annuities," which was issued in October, 1984. This report stated that nonguaranteed element plans present significantly different challenges to the management of the life insurance companies than do traditional par plans. Much of this difference can be attributed to differences in pricing practices.

Theoretically, participating plans are intended to provide insurance at cost to participating policyholders. Regardless of the exact technique applied, there are several principles on which there is general agreement. The first is that participating premiums are set at a level which can be shown to be adequate to provide the benefits promised under a wide range of economic scenarios. The second is that equity is generally maintained on a cell-by-cell basis so that one group of policyholders does not subsidize the cost for any other group of policyholders. And, finally, dividends are allocated by the contribution principle under which surplus is returned to policyholders in the same proportion as they have contributed to the divisible surplus.

At the same time, there is not general agreement on the theory of pricing indeterminate premium products. A wide variation of approaches toward the determination and subsequent redetermination of nonguaranteed elements can be expected to and does occur in the marketplace. Nor is there necessarily as much emphasis placed on the concept of equity. Because of the differing nature of the relationship between the policyholder and the insurance company under a participating plan, as compared to that which exists under a nonparticipating plan, it is expected that some fundamental differences in pricing philosophy would exist.

There are two key questions of pricing philosophy for a company writing indeterminate premium products. First, what factors does the company wish to use in its repricing actions? Second, what operating principles will best assure that these factors can be followed with operating results that meet both profit and marketing objectives? The Society committee recognized that there are several different approaches which may be followed, each of which might require a different set of operating practices if the company objectives are to be met. In the nonguaranteed element recommendations, emphasis is placed on the need to establish a plan of operation. In effect, a plan of operation for dividends is based on the contribution principle.

Simply stated, the actuary's responsibility for nonguaranteed elements is to document the plan of operations which underlies the determination of those elements. The actuary's responsibility with respect to the dividend recommendations is to assure that a plan of operation based on the contribution principle has been followed in the determination of the dividend scale.

The redetermination policy and the selection of solvency margins, marketing and profit objectives are management decisions. This is in many ways similar to the concept underlying the dividend recommendations, which states that the determination of the amount of divisible surplus is a decision left to company management.

The recommendations on nonguaranteed elements are somewhat more free form in nature. Both the aggregate cost of the nonguaranteed elements and the method of reflecting the nonguaranteed elements in the cost to individual policyholders are left to company management. The actuary must have an operation plan by which these determinations are made. Also, it is the actuary's responsibility to advise his client as to the effects of that plan on profitability.

When viewed in the context of the products to which they are addressed, there is not as significant a difference between the two sets of recommendations as might appear on the surface. Both sets of recommendations require the writing of an actuarial report. Each report documents the operation principles which were followed. There is, however, less freedom given to the actuary in determining the operational principles which were used in the distribution of surplus from those which are used in the setting of nonguaranteed elements. Both the dividend recommendations and those on nonguaranteed elements address the methods and techniques which can be applied in the determination of dividend scales or, alternatively, in the determination of nonguaranteed elements.

There are several parallel concepts which are contained in these recommendations. The concept of contract class, for example, is included in both sets of recommendations. Under the dividend recommendations, the specific term "experience factor class" is used. An experience factor class is a group of policies whose dividends are determined using a common numerical factor. With respect to the placement of a policy in a specific class, the dividend recommendations provide, first, that the placement of a policy within one class or another should be based on a uniformly applied criteria designed to group policies with similar experience characteristics. Second, the assignment of a contract to a class should not be based on the occurrence or nonoccurrence of a claim.

A similar concept is applied to nonguaranteed element plans, although it is used in a somewhat wider sense. Contract class consists of all contracts that a company groups together for purposes of defining nonguaranteed charges or benefits. It is generally expected that a contract class once closed will remain intact for the life of that business. Again, as in the dividend recommendations, the assignment of a contract to a class is not based on the occurrence or nonoccurrence of a claim. Generally, contract classes are made up of contracts of similar type and structure, where the nonguaranteed elements are based on the same anticipated experience factors which have been used over a continuous time period and which have similar marketing objectives.

The redetermination of nonguaranteed elements usually requires two types of factors: contract factors and anticipated experience factors. Contract factors are defined as values set forth in a contract emerging from the operation of the contract. This may be cash surrender value, amount of insurance, or accumulation value. The contract factors which have been used in the determination of nonguaranteed elements must be set forth in the actuarial report. Similarly, policy factors including cash values and reserves as well as actual experience factors, are used in the determination of dividend scales. Similar to the requirements of nonguaranteed elements, the policy factors used in the determination of dividend scales must be set forth in the actuarial report.

While the application of the policy values is similar, the application of the experience factors varies considerably. It is the intent that nonguaranteed elements be responsive to future anticipated factors, while the dividend scales be responsive to actual past experience factors.

Anticipated experience factors are those elements in the redetermination of nonguaranteed charges and benefits that reflect expected future experience. Examples include the incidence or levels of premiums, mortality, lapse, investment income, reinsurance, tax and expenses. The projected experience of a factor class means experience expected in the future as determined by the actuary through the application of sound professional judgment. The actuary's report should describe the anticipated factors used and identify any changes in the value of anticipated factors from the last redetermination.

By contrast, experience factors, as used in the dividend recommendations, are those elements which reflect actual past experience. Actual experience means experience that is determinable, available and statistically credible. When such suitable data is lacking, experience factors may be based on actual experience of other similar classes of business, either in the same company or from other sources.

It is generally anticipated that future nonguaranteed element charges and benefits should reflect the experience anticipated in the future, even though it may be worse than originally expected. In Interpretation One to the Nonguaranteed Element recommendation, it is provided that a specific provision for recovery of past losses or distribution of past gains in redetermination is a possible element of a company's policy. If there is such an intent, the actuarial report should specifically describe this element. There may be regulatory restrictions on this type of element and those restrictions must be taken into account and documented in redetermining nonguaranteed elements. There are many states which do not allow past events to be reflected in the redetermination of future premiums. Even if pricing methodologies suggested that past gains or losses may be reflected, this should be done through a specific element rather than through experience factors.

In the development of nonguaranteed charges or benefits, the actuary should conduct sensitivity tests of the potential impact that deviations from experience will have on future results. The actuarial report should contain a description of any sensitivity tests done, a summary of the results, and the advice the actuary may have to avoid or minimize the impact of variations. If tests are not conducted, the actuarial report should explain the reason for not conducting sensitivity tests. This is similar to the responsibilities set forth in Dividend Recommendation 21. There the actuary should conduct tests of illustrated dividends to judge whether those illustrated dividends could be paid in the near future. If there is a substantial probability that the illustrated dividends are not supportable, then the actuarial report is required to contain a statement to that effect.

Let me put the differences between the two sets of recommendations in context. The recommendations on nonguaranteed elements are documentary in nature. The primary responsibility of the actuary is to assure that a plan of operations has been developed by which the company can manage future changes in the nonguaranteed elements. The recommendations on dividends are methodological in nature. The fundamental responsibility of the actuary under those recommendations is to assure that the contribution principle has been used in the allocation of divisible surplus. The responsibilities are consistent, given there is considerably more freedom in terms of the generally accepted actuarial principles applicable to nonguaranteed elements as compared to the generally accepted actuarial principles applicable to traditional participating dividend scales.

A similar approach is used in the determination of dividends and nonguaranteed elements in terms of the technique, except that it is anticipated under nonguaranteed elements that they will be based on future anticipated experience, while dividends are based on past actual experience.

Finally, under both the dividend scale and nonguaranteed premium scale, projections should be made to determine whether the current scale is supportable under anticipated assumptions. If this is not the case, it should be clearly documented in the actuarial report.

It is more a part of current actuarial practice to provide a formal dividend report than it is to provide a formal report with the redetermination of nonguaranteed elements. This must be corrected immediately.

In practice, many of the issues which I have discussed have been addressed. In a great number of instances, however, a formal actuarial report is not prepared and given to the client. This is especially true where the work is being done, not by outside consultants, but where the work is done inside the company. These recommendations do not distinguish between consultants and corporate actuaries. They specifically provide that the company is to be considered a client of the corporate actuary.

In closing, if one reflects on the difference between the products, then the standards which are applied to dividend and nonguaranteed elements are very consistent.

PANEL DISCUSSION

MR. WALTER N. MILLER: I am one of the current IASB Board members, so these comments will reflect that experience. One of the best definitions that I've ever seen of the characteristics that a body must meet in order to be legitimately considered a profession, was one developed about twenty years ago by a committee of the AICPA. The two points they listed that have stuck with me most strongly were, one, there needs to be a defined and accepted body of knowledge that belongs to that profession and, two, the profession needs to have a set of coherent, logical, accepted standards of practice. Obviously, the main purpose of the IASB pilot project and hopefully its translation into a permanent ASB will be, if the Academy membership approves, recognition that we need to continue with that effort of developing a coherent, rational, accepted set of standards of practice. As far as the practical impact of these standards is concerned, it's possible to say that they could have considerable impact in the real world.

I was particularly struck by Mr. Doll's scenarios. They illustrate the potential for types of thought, and possible situations and relationships between actuaries and their management or their clients that we haven't seen before. I hope we're all able to support the possibility of scenarios like those developing as something good rather than something troublesome.

There is going to be, I think, a fairly detailed document prepared for submission to the Academy membership, probably in a few months time, in connection with their responsibility to vote on whether the IASB should become permanent. I've seen a draft of a big piece of that documentation. At the beginning, there is a list of the advantages that it is felt will be conferred on the actuarial profession from establishment of the ASB.

What will standards do for us? To me, one of the things that's very important now in looking forward to many of our activities, is that a coherent, rational, accepted set of standards gives actuaries a safe harbor, if they practice within those standards. I agree with the comments that have come from this panel, about what you might call the forthcoming crisis in policyowner expectations. I don't have any doubt that we're probably headed for something like that as a result of our collective illustration practices over the past years. There will be a lot of pipers to pay if those scenarios eventuate. If actuaries adhere, as they should, to these new standards, the public's view of their activities and their ability and what they mean to their employers and what they mean to their clients will, in the end, be significantly enhanced.

I'll close with an analogy. A lot of people say bad things about accountants, and particularly auditors, and especially auditors who say, "If your company decides it wants to continue doing this thing this way, I'm going to have to give a qualified opinion." In the end, however, I would submit that, in most cases, *that strengthens not only the auditing profession but it strengthens the client.* These recommendations give the actuary the opportunity to operate the same way. "Okay, management you can price this way, you can have this sort of policy with respect to objectives and redetermining premium rates, but I just want to tell you that my actuarial report is going to have to reflect that, and correct answers to the annual statement interrogatories will have to reflect that also." That's not going to turn things around in every instance, but it's going to give the actuary a legitimate bit of clout in some of these dealings that he hasn't had before. I would submit that that's going to be good, both for the profession and the company.

MR. DOLL: The comment about the safe harbor raises a question in my mind, and that's regarding the effective date of these recommendations. The recommendations were promulgated in January; they were adopted by the IASB Board last October. At what point in time should we be doing these reports? Should we go back and do a report for every nonguaranteed element product that our company is currently selling or should we wait until, going forward, we redetermine an element?

MR. TOZER: Before I answer that question, I would like to add a little bit to what Mr. Miller said. I think that most actuaries should look at the work that's being done by the IASB, as an assistance to actuaries and not necessarily as a threat or a demand. As actuarial standards are developed, that gives us, as individual actuaries, a benchmark to measure against as to whether we have done a complete job of what is expected of us as actuaries. Without standards, you have the risk of being judged with twenty-twenty hindsight. The actuarial standards board is attempting to develop those benchmarks that give you some protection and some help, so that you can say, "I covered the various items my profession recommended that I do, to do a complete job." Or, if you did not do a complete job, spell out or say in your actuarial report why you didn't. I don't think that the actuarial standards are saying that actuaries should get into conflict with management. They are simply saying that if you are asked to cut corners, put into your report that you cut corners because you were asked to cut corners. That gives you the assistance that if something goes wrong later on, you have told everybody and documented that you cut those corners because somebody asked you to cut those corners. The important thing that we're asking is that actuaries give good, complete, documented information so that if questions arise later on, everyone can point to the fact that they were given the information to make a valid decision.

As we all know, the marketplace is becoming more and more competitive. As a result, management is having to make more and more aggressive decisions. I believe that actuaries should give whatever help they can to management making those decisions, but actuaries shouldn't be taking the role on themselves to make those management decisions for management. They should give management the necessary information to make the informed decision and document what they've done in giving advice.

These recommendations are now in effect, and individual actuaries should take a look at the work they've done in the past. If they believe there are certain areas where documentation would be good for the management of the company and themselves, they ought to prepare an actuarial report. In areas where they believe that that is not necessary, under the circumstances, then they should make judgment that way. Obviously, if they've got areas that are going to come up for review in the near future, the need to do an actuarial report on what's happened in the past may not be necessary. You have to take a look at each individual situation. Actually, these actuarial standards are really applications of a lot of good actuarial professional conduct standards that have been in place for quite a while. We basically are clarifying them and amplifying them to try to encourage the profession to do a better job of communicating what they're doing.

MR. DOLL: We have been talking about the warm feeling that we can get from having a safe harbor -- that if we comply with this safe harbor we can feel protected. But that's a two-edged sword. If you don't comply with these recommendations, then now we have something that we can get hung by.

MR. DOUGLAS A. SZPER: I am the product actuary, valuation actuary, corporate actuary, and chief financial officer. I maintain microcomputers, and I empty wastebaskets. I'm a little disappointed that more companies aren't represented here. I'm not sure that all the companies recognize the significance of these recommendations. Personally, I appreciate these recommendations and the directions that the IASB is going. Actuaries for small companies face special challenges. Your first scenario, where you're asked to respond immediately to an actuarial question, is a daily occurrence for me. These recommendations put an additional burden on me, in terms of time to write the report. I am pretty good at getting the answer quickly, but to sit back and write the report can cause a lot of delay. In a small business, which my company is, it's hard to justify and explain to management, of which I'm also a part, the reason why an external body like the Academy is putting this additional expense burden on the company and indirectly slowing down that process.

It's a challenge that we have to deal with, though. The need and the value of that documentation, as you've said, is very real. Having that information for anyone who looks at the work in the future will be very valuable. During the past few years, it's been quite an uphill battle but somewhat successful, in my attempts to educate management on their responsibilities in making the assumptions for pricing products. It's not my responsibility to set assumptions and dictate what the pricing is, it's a shared responsibility.

These recommendations do help in clarifying the separate role of the actuary as the technician who advises management in its decision making process. Regarding the second scenario, the issue of marginal expense pricing, that's another ongoing battle. I successfully avoid complete break-even pricing, simply by educating the management group towards the realities of profitability of a life insurance company.

Scenario 3 raises the most concern related to the types of funny business going on in sales illustrations. My concern is that there may be a number of companies that simply don't consistently comply with the recommendations in their strictest interpretation. The burden may fall onto companies that do comply and, in effect, lay out their entire set of assumptions. I have worked with our field force directly in doing competitive comparisons. I've seen a number of different things that bother me. One is the situation where the agent is allowed to choose the level of future mortality improvement in his illustration, built right into his floppy disk. Does the actuary comment on the different assumptions that are used by the different various agents? Another is the common practice of current credited rates that may be supported by a limited amount of investments that can be made today but the rest of the investment portfolio is dragging behind at a lower rate. Should companies recognize that as a subsidized rate and report it has something that can't be supported? Another situation was where an agent modified the company's illustrations and produced an incorrect illustration of the effect of policy loans on the dividends. Again, that's a situation where the actuary, I hope, has no involvement but it should be a concern to many companies.

Finally, I have a general concern about the use of group contracts that give the appearance of being individual contracts but avoid individual policy regulations and nonforfeiture laws. In summary, the future is an easy place to do business, and that seems to be what's going on.

MR. TOZER: I'm very sympathetic with the many hats and the pressures that develop in a small company, and the tendency to react because of the urgency of time or the lack of time to do things quickly and simply. I worked in small companies in the past, and I discovered that, although I didn't have time to do certain things at the time that I put something together, I seemed to find time, six months later, to spend twice as much time trying to straighten out the mess I had because I had not taken the time to do it correctly in the first place. When we talk about actuarial reports, we're not necessarily talking about huge volumes. What we're really saying is prepare just a short memorandum, whatever it takes to document the situation.

As far as sales illustrations are concerned, a key element in the interrogatories is that they apply to illustrations authorized by the company. Those words were taken very purposely because, with the various software packages available today, we all are facing the problem of creativity by field people in developing their own illustrations. There's no way that a company could handle and review every one of those imaginative illustrations that are going on out there. So the interrogatories are attempting to get clarification on what authorized illustrations are being presented.

One of the reasons we developed these interrogatories was that we believe it is necessary to have a disclosure mechanism with the NAIC. These interrogatories are, we think, a reasonable middle ground. If we didn't put something together like this, we were going to see something being developed by the regulators themselves. We were concerned that those regulators would require even more extensive disclosure of details and so forth about our practices. We attempted to develop something here that we hoped would be a middle ground that would meet much of the desires and needs of the regulators but would be an environment that companies felt that they could operate in without too many problems. If we have something here that neither the profession, the industry, or the regulators like, it means we probably have pretty good compromise.

MR. WILLIAM C. KOENIG: My experience is that various companies prepare their Schedule M and dividend interrogatories with various levels of intensity. Occasionally, they are used as competitive pieces. For example, one company's actuary may state that there is no substantial probability that the dividend scale will be reduced over the next two years, while another company's actuary may be less optimistic. This sort of thing generates a certain amount of pressure for the actuary of the latter company. Other than professional pride, what enforcement or oversight mechanism in in place to assure that all actuaries approach the nonguaranteed element interrogatories on a consistent and professional basis?

MR. ROBINSON: We've had some discussion about the market surveillance aspect of the triannual examination process. I am very hopeful that the states are going to turn over certain of the accounting functions to the independent auditors. We've been working in Indiana to cause that to happen and we're starting to make headway. This would enable the regulators to deal with the things that are of principal importance to them, specifically, solvency and market conduct. Those two aspects are much more important than adding columns of figures. So, I would hope that in the market conduct procedure, the states will do a better job of taking a look at the supplements, the interrogatories, looking at the company policy, and starting to exercise some of their regulatory oversight.

There is always going to be the dilemma of doing the right thing and then having it used against you. I think we're all faced with that; we're faced with that certainly in the way we do our tax reporting, we're faced with that in the way we run our businesses. It's really a matter of ethics. From my perspective, having served with the ACLI on several committees, the immediate response is to say there ought to be a law and to try to ram through very heavy repressive kinds of regulations. The illustration shortcomings that were mentioned by Mr. Szper certainly may cause that kind of response. There are going to be some bad apples. Self-policing is not easy, but I'm convinced that overregulation is not the answer either. Actuarial responsibility is going to be a key element in causing this to work.

MR. HOWARD H. KAYTON: I have two concerns about the recommendations. First, the role that we cast the company actuary in is essentially that of a regulator. This report that we're producing is not really an action-oriented report. We're not telling management what to do; we're being put in the role of guiltmakers. I think it's wrong. If this is the direction the IASB is heading, I think they should really review this, and see whether they want to cast the actuary in an adversary role with his own management.

The second point is that the subject we're talking about is nonguaranteed elements. When these products were developed, there was no intention they be treated the same as participating policies. We simply issued policies with nonguaranteed interest elements; that's exactly what they were. Our company, for example, issued policies in competition. Some had guarantees for long periods of time, as long as seven years; others did not have guarantees. The policyholders knew what they were buying when they were buying policies with nonguaranteed elements. Now we're retroactively changing the nature of the policies and essentially telling the companies that, if they change their method of crediting interest rates on the nonguaranteed policies, then they should be looked upon as having violated a trust with the policyholder. I don't believe there was a trust to begin with.

MR. DOLL: I do not believe that the recommendations require you, as you say, to lay a guilt trip on management. All the recommendations ask you to do is give an objective report to management, as to what you believe the results of their actions will be. The recommendations do not require the actuary to give an opinion as to the rightness or wrongness of those actions.

MR. KAYTON: There is a section, Section 5, entitled, Actuaries Advice. "The actuary's report shall present the actuary's specific advice." So, it isn't just a matter of sitting back and being a disinterested commentator on what's going to happen with these actions; we're still giving advice. You're advising management.

MR. DOLL: Advice does not necessarily mean, "Here's what you should do," but, "If you do this, this will happen" and "If you do that, that will happen."

MR. TOZER: I want to emphasize that the instructions to the annual statement talk about an actuarial opinion but do have the phrase "an actuarial opinion similar to the one illustrated below." You do not have to use word-for-word the actuarial opinion that's in the instructions. I hear Mr. Kayton's comments about not drawing a connection between dividends and nonguaranteed elements. But, in our work with the NAIC, we ran into a situation where they were forcing us into that mold. I have some of the same concerns about the emphasis we're placing right now on actuarial opinions. A lot of these opinions should be management opinions and not necessarily actuarial opinions. I hope that we can make some progress in that whole area and not necessarily on this particular issue of nonguaranteed elements. The whole topic of actuarial opinions needs to be revisited.

MR. SELIG EHRLICH: I'd like to lay out a scenario and then ask two specific questions as to what the recommendations would require. Say you have a stock company that offers an interest-sensitive life product. At the time it was designed, a very tame investment strategy was expected, nothing but corporate bonds. The company settles on a certain interest margin to yield some profit, let's say a hundred basis points. Time passes and someone approaches the company and says, "If you give me the money instead, I will give you three hundred percent on your money in two years with nothing in between." The company likes the idea. They put the money in this new investment and, to make the policyholder indifferent, let surplus stand behind the current credited rate. For the next two years, if interest rates stay the same, they continue to credit the same rate and take the hit in earnings. Two years pass, the company keeps faith with the policyholder by maintaining his credited rate, the investment comes through and the company has a windfall.

The first question is, in the interim period where the actual assets could not support the credited rate, does that have to be disclosed in the interrogatories or elsewhere, if the company has made the decision to stand behind the policyholder and has in fact done so? The second question occurs when the investment comes through and the company keeps the windfall. Are they in violation because, now instead of a hundred basis point margin, they've made a terrible pile of money?

MR. MILLER: You need one more thing in your scenario. What did the company say in the first place, when they sold the policy?

MR. EHRLICH: Originally, it was expected that it would be a tame investment strategy, nothing but corporate bonds with a certain holdback.

MR. DOLL: A question that might be partially related to what you're asking is, if the actuary does his report with a given methodology, and the company management later changes that strategy without consulting the actuary, is the actuary under any obligation to prepare another report?

MR. TOZER: No, I think that the recommendations state that when you give advice, you need to give an actuarial report.

MR. DOLL: So, it's not up to the actuary to be a watchdog.

MR. TOZER: That's right, there's no situation that simply says that if the company makes a decision and doesn't ask for your advice, you've got to force your advice on the company. Or, there's nothing that says here that if the company does something, that you're responsible to blow a whistle. What we're saying is, when you are asked for advice, then you need to document that advice.

We are looking here at the current situation but, as Mr. Robinson mentioned, what is being proposed to the NAIC is that, in the cost of disclosure regulation and the advertising regulation, the company be required to make a statement about what its game plan is.

MR. EHRLICH: Are you recommending that policyholders be told the exact game plan? If the company is willing to stand behind its guaranteed rates, do we have an obligation to disclose to our policyholders what our asset selection is?

MR. TOZER: The ACLI is going to recommend a change to the Cost Disclosure Model Regulation. If the policy has a nonguaranteed factor, which is the terminology they use in that regulation, the policyholder will get a statement indicating that the insurer reserves the right to change the nonguaranteed factor any time and for any reason. However, if the insurer has agreed to limit this right in any way, it must state this.

Getting back to the scenario at hand, I think management has the right to change its mind if the policy was sold on the assumption that the company has the right to change the rate any way it wants to change it. If promises were made that the credited rate would be based on the earned rate and if that promise is being changed, then that needs to be communicated.

MR. EHRLICH: I'm concerned that in the two-year period, since the actual assets are not supporting the credited rate, the actuary might have to say, "We are now currently crediting a certain rate, but there's no way in the world we can support it."

MR. DOLL: I think you have to go beyond this two-year period, because you do anticipate that company surplus is sufficient to credit the current rate during the two-year period. But you have to look beyond the two-year period and, if what you foresee happening beyond the period is such that you think that your current illustrations can reasonably be supported, that's probably the key to your situation.

MR. ROBINSON: The IASB Recommendations refer specifically to several jurisdictions that have regulations which apply to the determination and redetermination of nonguaranteed charges. There are some states where you have to file a game plan. If you're going to change the game plan, you have to let them know. It's going to be very important that the pricing actuary, the actuary that's responsible for creating the report, and the people that are doing the policy form filing in providing those, get their acts together. You do have some states that require that the board of directors act on any determination or redetermination.

One of the things that we found in looking at Schedule M supplements, and I'm sure it's going to be true of the new interrogatories, is that it doesn't take a great deal of ingenuity for an actuary to provide the kind of disclosure that ought to be made and yet do it in such a way that anyone looking at it would not feel that the company is doing something reprehensible, if the company is pursuing a reasonable plan.