RECORD OF SOCIETY OF ACTUARIES
1988 VOL. 14 NO. 4B

NON-FORFEITURE PRINCIPLES

Moderator: DOUGLAS C. DOLL
Panelists: ARDIAN C. GILL
DANIEL J. MCCARTHY
WALTER N. MILLER
Moderator: DOUGLAS C. DOLL

- Presenters will discuss the results of deliberations by the Society of Actuaries Task Force on Non-Forfeiture Principles

MR. DOUGLAS C. DOLL: We are going to operate this session just like a meeting of the SOA Committee on Non-Forfeiture Values. At the very beginning of a meeting, most committees normally would read the minutes of the previous meeting, discuss them for 30 seconds, and then go on to new things. But for this task force a typical meeting includes a half-day arguing about the minutes. There are a couple of reasons for this. First of all, there was always somebody who didn't attend the previous meeting and he would not agree with the conclusions in the minutes. We also would have people change their mind from one meeting to the next. Finally, we had conflicts as to whether the minutes accurately described the mood of the previous meeting.

We are going to do the same sort of thing here. We are going to present the minutes of meetings that we have had over the past year and a half. Our preliminary report of tentative conclusions represents the "minutes" of our work to date. We are going to spend just a very short time presenting this report and then we are going to open up the rest of this panel to a discussion of those "minutes."

The only differences from a typical meeting are that we are going to be limited to 90 minutes and that we are going to record this discussion so nobody can say at the next meeting that he really didn't say what the minutes record.

I would like to introduce my panel. Walt Miller is the chairperson of the task force. Dan McCarthy is a member of the task force. Walt and Dan will be presenting the minutes of the meeting. We also have a third person on the panel, Ardian Gill. Ardian was vice chairman of a predecessor committee to this task force. That is the Unruh committee that had a similar charge in 1975. We are going to let Ardian lead off on the discussion of the minutes after they are presented.

Before reading the minutes of the meeting, you need a little bit of background as to why this task force exists and what it is we are trying to do. The genesis of this task force was a letter from John Montgomery to the SOA about 1.5 years ago. It was a one-page letter. Let me read a little bit of it: "Since the report of the 'Unruh Committee,' concerning non-forfeiture requirements as applicable in the early seventies, many new products of a deposit fund type have evolved. Much of the current regulatory problems with non-forfeiture values for universal life and similar type plans, stem from the need for some form of retrospective approach at least for cash surrender values. I am asking that the Society form a committee to review the underlying principles elicited by the Unruh committee report, considering the concepts of equity and solvency concerns in the light of current and anticipated conditions as compared to those of the 1970s." In response to that letter, the Society did form this task force, and the handout that you've got represents a preliminary version of an interim report. It is not meant to be our final conclusions.

Finally, I would like to put some historical perspective on things by summarizing some of the early history of non-forfeiture values. My definition of early history is prior to 1950. I started to worry before the meeting whether that would offend any of our panelists, so I did research and found that all of them received their fellowships after 1950. So it shouldn't bother them too much if I refer to that as early history.

How many persons here are familiar with the story of Elizur Wright and how he went to the U.K. and saw the auctions there and he came back and developed the standard non-forfeiture law? Well, you are all wrong! Elizur Wright didn't develop the standard non-forfeiture law. In fact, it took 100 years from the time Elizur Wright saw those auctions to the time that we actually had a standard non-forfeiture law. It was in 1844 that Wright visited the U.K. It was 1861 when the first non-forfeiture law was passed in Massachusetts, and that law only required extended term insurance. Another 19 years passed -- it was 1880 when Massachusetts passed the first non-forfeiture law with cash surrender values. (It is noteworthy that, at that time, there were already some insurance companies that were providing cash surrender values.) But, then, from the period of 1880 to 1941, there were really no significant developments from a legislative perspective. Interestingly, many of us think that the Armstrong Investigation had a lot to do with non-forfeiture values, but it really had to do mostly with deferred dividends and some other practices; it didn't have much to do with non-forfeiture. By 1938 only 23 states required cash surrender values and ten states had no non-forfeiture laws at all.

The Standard Non-forfeiture Law came about related to a desire to change reserve standards. In the early 1940s companies were strengthening reserves because interest rates had dropped quite a bit and at that time non-forfeiture regulations tied cash values to reserves. As companies strengthened their reserves they were also being forced to increase cash values, which did not seem to be a reasonable result. The Guertin Committee of 1941 set about to come up with a standard non-forfeiture legislation and they came up with the methodology in the Standard Non-forfeiture Law that we are familiar with today.

There are some interesting tidbits of information in the early history. Would you believe that way back in 1891 Shepherd Homans argued that there should be an additional deduction for cash surrender values to reflect adverse financial selection? We think our generation of actuaries created the analysis of C-3 risk but way back in 1891 Shepherd Homans was making this point. It is not clear from the history I read but I believe he was thinking more in terms of liquidity risk than he was the interest rate risk.

With that background in mind I would like to let Walt Miller discuss the first few conclusions of our task force and then Dan McCarthy will finish up the rest of them.

NON-FORFEITURE PRINCIPLES

MR. WALTER N. MILLER: At the Board of Governors meeting earlier this week, this report was distributed for the Board's information and discussed briefly. One item that several of the Board members expressed some concern over was the use of the word "principles" in the title of our task force and as they apply to our emerging work product.

The definition of what is a principle and what is not a principle and what is a standard is something that is still being clarified. I would just say that for better or worse, from the very beginning it has been the intention of our task force to suggest what we think should be the fundamental concepts that should apply and underlie the next revision of the standard non-forfeiture law. For purposes of that task, whether you call them principles or something else is not terribly relevant. If it is decided that these are not principles, I don't think it would bother anybody on the committee.

At this point, let's turn to our tentative conclusions as outlined in the executive summary of our interim report. The first one is that from a pure theoretical actuarial standpoint, we don't see any reason for requiring guaranteed non-forfeiture benefits at any level. But that's theory, and our committee wanted to address the real world, because we want to make a difference in the real world. Here, we don't feel that our society is ready to totally abandon non-forfeiture regulation. If there was an active and equitable secondary market for life insurance policies in existence right now, that might militate against the need for any non-forfeiture regulation, but we don't see such a market in existence right now, nor do most of us foresee much chance of one developing in the near future. Our report mentions that some of us feel there may be some elements in society that would oppose such a development under any circumstances. That's a long-winded way of saying that our committee -- strongly but not unanimously -- thinks this is not an appropriate time to suggest the abandonment of all non-forfeiture regulation.

Moving to the next point, I think that when it became known that our committee had been formed, a number of people in both industry and regulatory circles thought that what we should accomplish -- and would accomplish -- was a relatively quick fix. In other words, what we should do was to update the standard non-forfeiture law -- which is framed on an essentially prospective basis -- for traditional coverages, develop some retrospective approach to cover the non-traditional coverages, and that would be that. Our committee feels very strongly that that wouldn't be a constructive step. If you do that, you are going to have grey areas as the turbulent pace of product design and development continues. If you give companies a chance to look for the best break under a policy that could be viewed as either traditional or in the Universal Life (UL) family, they will probably react to that. So we believe that whatever approach is adopted, be it essentially prospective in nature, retrospective in nature, or anything else, that one approach ought to apply across the whole spectrum of life insurance policies. This is commented on in Item 2 in the summary. We believe that those principles probably ought to be applied to annuities as well.

How are you going to do it? Item 3 in the summary says that after looking at a number of possible approaches, we gave some close examination to two which we have characterized as an asset share approach and an auction value approach. I will read you the description of the auction value approach as it appears in Item 3. "Intended to approximate the value that could be realized by the policyowner by selling the policy in an active secondary market, if such a market existed."

I think you can see that this kind of approach has to be prospective in nature. When you decide how much you are willing to pay for a policy, you are going to be looking at the potential cash flow streams to and from the policyowner and beneficiary that could exist under this policy in the future.

I don't have to comment much to a group like this about the basic nature of an asset share approach which is obviously retrospective in nature. I would point out that we think that any asset share approach that is used ought to make provision for what we say is a reasonable risk and profit charge -- it should not be an exact mirror of any particular part of funds that might be built up under the policy.

Our committee's strong but not quite unanimous choice was to favor the retrospective asset share approach. The ground rules for our characterization of a good approach or how it should behave is shown on the bottom of page 7 of our report. The main reasons for preferring the asset share approach, or perhaps more accurately not preferring the auction value approach, are outlined at the bottom of page 8. We thought that there would be many difficult practical problems dealing with an auction value approach as the basis for developing minimum non-forfeiture value regulation.

For one thing, a prospective approach might have to be dynamic in nature (looking at the type of economy we have now and the outlook for the future). This could be difficult. The auction value approach also has the interesting property that if you look at two policies that are the same except for their levels of gross premiums, the auction value approach produces a lower non-forfeiture value for the policy with higher gross premiums. We were not at all comfortable with that concept.

The fourth item in the summary says if we have crossed the bridge as to whether there should be any non-forfeiture regulation at all -- the next milepost we come to is that of saying what types of non-forfeiture benefits should be required. Here it is our feeling that, subject to de minimis exemptions, our basic concept of equity is satisfied by having laws or regulations that mandate minimum paid-up insurance non-forfeiture benefits.

Our committee feels, unanimously in this case, that if you have such minimum paid-up benefits, it is not necessary for the law to mandate minimum levels of cash surrender values. We believe that for a variety of reasons. One of them was important in the minds of all the committee members, and perhaps wasn't recognized nearly as well in the days of the Unruh Committee deliberations in the 1970s and prior thereto. This is the cost of providing book value based cash surrender value guarantees in an economy that has the degree of turbulence and fluctuation built into it that we have seen and have no reason to expect won't occur again.

MR. DANIEL J. MCCARTHY: Walt structured this so he got to talk more about the conclusions and I get to talk more about the non-conclusions. As both Doug and Walt have suggested, the committee that has been appointed and has been working on this task for a long time now is a committee of people with rather different views. That is both its strength and its limitation. Obviously, if we had only one person we could present a more unified report and consensus.

The fifth point in the executive summary of the report picks up on something Walt said and perhaps it's helpful to put it in terms of contrast to the position of the Unruh Committee. The Unruh Committee said, as we have said, that an asset share concept is the best way of figuring out the equities involved in minimum non-forfeiture values. An asset share concept is a retrospective concept and yet the law that emerged from that, like its predecessor, is essentially a prospective law. As we thought about the problems of traditional and non-traditional product forms as Walt indicated, we concluded early, but not immediately, that we ought to have some mechanism that would be uniform for both. It wasn't necessarily clear whether that was a prospective or retrospective or conceivably some other mechanism that we hadn't thought about. We have concluded that it will be easier to harmonize the various product forms using not only an asset share standard, which is retrospective, but a retrospective method as well. Thus, we recommend a retrospective method -- one that will converge to the maturity values, assuming that the policy has one -- for determining paid-up non-forfeiture values.

So the fifth conclusion that you will see says very simply that that's what we concluded and if you turn back into the body of the text to find out a little more about that, you won't find any. The reason you won't find any is that while we have concluded that that's what we should do and can do, we don't yet have a treatise with any hard degree of reasoning as to how that will be accomplished. I would suggest to you, picking up on Walt's point about comments, that not only would we seek comments on our conclusions but any suggestions you may have about particular product issues or particular suggestions that will be helpful to us in the next phase of our work. We would appreciate that very much.

Walt said, in one of the points that he was summarizing, that the group has concluded that you don't necessarily have to require that a policy which would have paid-up insurance non-forfeiture values have cash values. In other words, a zero cash value product should, with proper disclosure, be allowable in the United States.

Point 7 goes beyond that and considers whether for products that do have cash values, there should be some formula for a minimum if there is going to be a cash value at all. Let's set aside the zero cash value family of products. You will see that this page is striking in setting forth our non-conclusions on the point. At one extreme, there are people on the committee who feel that there should be no restrictions at all, other than presumably a disclosure restriction that makes it clear what the actual cash values are -- that is point (a).

Point (b) says: well, now there should be something to avoid bizarre-looking patterns of cash values, but that's all there should be. In other words, there could be perhaps a regulatory formula and a company would have to pick its own parameters (perhaps within some limits, perhaps not) that would plug into the formula that would guarantee some kind of consistency from period to period, but that's all you need.

Point (c) is tighter than that but there are two choices. There are some people who feel that, in fact, there should be a prescribed minimum for cash values and that those could either be directly linked in some fashion to the insurance non-forfeiture values or not linked. We have had vigorous debates as to what the word link means -- we have had difficulty formulating a common language to talk about this issue because at one extreme "linked" says that you take the calculated present value of an insurance non-forfeiture benefit. That's the tightest link you can imagine. You can imagine other kinds of links looser than that, so we are still trying to find a way to talk to ourselves on this subject.

You will see a further discussion of some of the pros and cons of that back in the report. You will sense, if you read that, that no matter where people are on the subject we did agree in our own way with apparently what Shepherd Homans thought a century ago -- there is a lot of concern about company protection which grew out of (partly, but not entirely) the interest rate spikes of the early 1980s. That is a useful transition into committee summary point 6. Point 6 says, whether you have a minimum cash value standard or not, any policy which has cash values (obviously values that meet a minimum standard if there is one) should be allowed to have a mechanism within the policy which would allow the adjustment of those cash values to meet economic circumstances as they change over time. That would apply for cash values but not for insurance non-forfeiture values. A company would not be required to include such a mechanism but it would be allowed to include such a mechanism.

One of the reasons the committee is conservative on the question of cash value levels is that we foresee that, while there may be some companies that would like to make use of such a mechanism as is envisioned in point 6, to adjust cash values to adapt to changing economic circumstances, there are other companies that won't wish to do that. As an alternative, a company ought to be able to rely on a conservative standard.

You will see in the body of the report a discussion that sets forth regarding point 6 some of the principles that ought to apply to an economic adjustment standard if there is one. It ought to be prospective in nature. It ought to converge as the contract converges to maturity so that, for example, one day prior to maturity you don't get any large adjustment. It ought to be spelled out in the contract as to exactly how it would work, and it ought to be both up and down. That is to say, a policyholder needs to be able to benefit from it under the appropriate circumstances as well lose cash value under the appropriate circumstances. It raises all kinds of questions about links to policy loans and how that would be structured. But the principles we have set down are something we think that a company ought to be able to do.

I hope you have gathered from my presentation some of the things that we do have views about and some of the open issues, as well as some of the mechanical problems we are confronting. It is possible that even a one-person committee would not have solved the unanimity problem. This summer, I saw someone walking around with a t-shirt that said "I'm not a schizophrenic and neither am I."

MR. ARDIAN C. GILL: First, let me say to the writer of the report, I think you have done a very good job in this "ventilation phase," when everybody gets to express his favorite and perhaps ill-considered point of view. You have to let 100 flowers bloom, and I think you have written a good report. The best part of the report is the lengthy segment of quotations from the Unruh Committee report. I urge you all to read that carefully and put it under your pillow. You left out my favorite phrase which was "Equity, like beauty, is in the eye of the beholder." That is what we used to precede the discussion of equity from different points of view -- the agents, the companies, and, of course, the policyholders. Each one has a slightly different view of what is equitable. That, I think, is a section worth reading.

I was surprised at your remark, but then I realized you are probably right, that the Unruh Committee report had practically no discussion of principles. I don't want you to think that we were unprincipled -- it was not that we didn't spend any time on principles, it was just that we didn't write up this ventilation phase. After a lot of discussion of different ideas, like no cash value policies, we followed the lead of our very pragmatic chairman -- he just wanted to get on with the job -- fix things like deposit term and elbows in the cash value scale, and so we did.

We went on to address the then problems of the existing law. As a result of our recommendations, you find that there is no huge first-year expense allowance if you charge a big first-year premium, the elbows are gone, discontinuities are gone, you don't have to send 50 pages to New Jersey and analyze a 10-year term and the policy together to show that you comply with the law. I would say that our committee succeeded in updating the technical aspects of the law. At least we proposed them; they didn't all get into the legislation.

The major failure of our committee was on UL insurance -- it was just coming in then. We had Alan Richards on our committee from the Life of California. They were just about to bring out the first UL policy and he wanted to address it as a retrospective accumulation. The reason we didn't go along with his point of view is also articulated in this report -- and that is a statement that retrospective accumulations lead to rate regulation. We permitted the threat of regulation to preclude what might have been an opening to a freer market for UL. Of course, New York went ahead and regulated rates anyhow when companies filed the indeterminate premium policy. They put in regulations on how you can make those premiums behave.

I would like to make a suggestion to the committee and perhaps raise one or two questions in the process. It may be time to just forget about principles, what is a principle and what isn't -- you've had your discussion and everybody has his ideas out.

I think the current report is somewhat unfocused and merely reflects the phase that you have gone through. It is not unique to you; a couple of you have mentioned the Society's Board questioning the use of the word principle and well they should -- they have been arguing about it since the mid 1970s. I was on the Lindsey Committee when they asked, "Should we articulate principles?" We said, "Yes, we should articulate principles and here is what a principle looks like." We gave them examples but they are still having trouble deciding what a principle is, and you will as well. I think it was Senator Dirksen who said, "There is a time when you must rise above principle," and I think that time has come.

The problem in the current law is that UL is not clearly and cleanly addressed. You might look and see if universal variable life is properly handled. There are things like group variable and group universal variable. At the time we were looking at this I think Crown Life had just brought out a product called GOLI which was Group Ordinary Life Insurance. Then the IRS said you have to split it into 2 pieces so they brought out another product which they called BIGOLI!! The new version of that is group universal -- I suspect that the current standard non-forfeiture law doesn't address that too well.

Your committee would do well to address the unaddressed or the items that are poorly addressed. You would do well to forget about rate regulation -- it is already here. Most of the newer products developed now are more in the nature of a security anyway so you have at least two kinds of regulation. The question of market value adjustments has been with us but is already here as an effective mechanism in variable life insurance -- the separate account idea is an automatic market value adjustment. Practically nobody sells insurance anymore. We are all selling investment products or accumulations.

I would like to ask one question of the committee. What is the principle underlying the idea expressed that you don't need a cash value when you have an insurance non-forfeiture value? As I said, we are not really selling much insurance, so it sounds first of all a little archaic. It bothers me a little bit that this would reinforce the stereotype that you can never get your money out of an insurance company.

There was a joke in the *Journal of Commerce* a week or so ago. A Russian lawyer, Czechoslovakian baker, and an American insurance executive decide to go hunting. They park their station wagon and go into the bush to look for a campsite, with the baker in the lead. He dashes into an opening, and there is a bear, and the bear promptly eats the Czech baker. The Russian lawyer and the American insurance executive dash back to the station wagon and get their guns, come back to the clearing and there are now two bears, a male and a female. The Russian says, "We have to decide which one swallowed the baker." The insurance man says, "It's the male." He picks up his gun and shoots the male bear. The female runs away. They go over with their hunting knives and open up the bear and there is no baker. The moral to the story is never trust an insurance man who says, "The Czech is in the male." That, alas, is the problem the industry has had. I am afraid if you say a person can pay in money to his insurance policy and create an accumulation, but when he comes to take it out he has to buy more insurance, it is just not going to do us any good. Just when you need the cash you've got to take more insurance.

Just a minute or two on the no-cash-value policy. I read those discussions with great interest. Back in the body of the report you will see there was an earlier initiative -- Charlie Greeley had a sub-committee and tried to get that through. If you do that you would probably want to limit it to fairly high amount policies. I don't know why that didn't succeed; maybe John Montgomery can tell us later. I think failure of that initiative illustrates that it's probably not something that the world needs. With the advent of UL insurance, by paying the lowest premium you can get away with, you can fabricate, if not a no-cash-value-policy, at least a low-cash-value policy.

The idea of the secondary market is pretty interesting. I have some skepticism about it because there are plenty of policies around with very low cash values and no secondary market has sprung up. That is not to say that a no-cash-value policy won't give rise to such a market, but I do have some skepticism about it.

The committee came down rather hard on the idea that if you have a high premium policy in an auction you would get a lower value for it. They found that somewhat difficult to accept but I thought the Appendix B in this report explained it very nicely. If somebody bought a policy with a high premium and makes a bad bargain you couldn't expect somebody else at an open auction to make the same bad bargain. He is going to reflect the market value of that policy unless you follow the greater fool theory.

To sum up, I guess you have had your ventilating session and written a good report and perhaps now it is time to go on with the list of problems that exist and go ahead and fix them.

MR. DOLL: Ardian mentioned the lack of a secondary market. The September 24 issue of *The Economist* has an article about a development in the U.K. For those of you who aren't familiar with the U.K. market, there is a class of policies there called "with profits" business. A lot of it is endowments. They have an accumulation value, but a large percentage of the accumulation occurs in the last three or four policy years. According to this article, referring to the low surrender values a few years prior to maturity, it says: the surrender differences are so great they have prompted a new business, a market in secondhand "with profits" policies through a middleman called Policy Network. It works like this: instead of surrendering a policy, a policyholder sells it to an institutional investor for roughly 20% more than the surrender value offered by the insurance company. The institution continues to pay the premiums on the insured's life and collects either when the insured dies or when the policy matures.

So, I guess if the legal framework permits it, if the differences do get great enough we would see some sort of secondary market spring up.

MR. PAUL E. SARNOFF: I would like to compliment the committee on its decision to go with the asset share approach rather than the auction value approach. I am a little disappointed that one of the reasons that might have been given for rejecting the auction value approach was not given. It seems to me that there is a problem about having a secondary market for insurance policies. A secondary market means that there would be a third party entering into the contract, taking over the position of policyowner. That puts the insured in the situation of having a contract out on his life where there is somebody who has an adverse interest to his continued existence. It seems to me that there is something ethically reprehensible about such a situation. That reason should also be included in your reasons for rejecting the idea of the auction value.

You say there should be no cash value required, just paid-up. That is just a further encouragement to the idea of the development of a secondary market. Since I have already indicated that such a secondary market is reprehensible, I am concerned about the fact that you don't require cash values.

MR. RICHARD M. STENSON: I would also like to congratulate the committee on the report. I do so having only read the executive summary but I am sure it is a full reflection of the total report. When I first heard a couple of weeks ago that you were looking at this auction approach, I wondered why. Why on earth would you want to look at that for some of the same reasons that Paul mentioned? But, as I look at the total report, I think it is a very good service to take a "ground zero" look, as I gather you have, of what we really should be about in looking at what value an insurance policy should have. I certainly agree with your conclusions that we ought to end up with the asset share, looking at it retrospectively, rather than trying to use the auction value approach.

I would be concerned if there were a secondary market relied upon for people to get value out of the policy. You could have long term whole life policies with level premiums, people have paid premiums for many years and maybe they don't get around to paying one because they are too sick at that age or for some reason and the policy can then lapse without value -- I wouldn't want to be writing letters to people who had coverage for 50 years and forgot to pay the premium and then I say, "Tough, if you are in good health, get a new policy for ten times the amount that you have been paying." That's not an actuarial reason but a nice practical thing that I think should be considered and is taken care of by providing a retrospectively determined non-forfeiture benefit.

MR. MCCARTHY: A point of clarification -- we would have assumed that it would be required that such a contract would have an insurance non-forfeiture benefit, for example, extended term. If you were a long way into the contract you wouldn't lose your position by virtue of failure to pay a premium. I would assume also, although we weren't looking at this point, that reinstatement provisions and so forth would also operate. So, I don't disagree with your conclusion, but I'm not sure it's quite the desperate situation perhaps that it could be.

MR. JOHN O. MONTGOMERY: Ardian, after Alan Richards left the Unruh Committee he came to me. I thought he had a good product so I encouraged him to market it in California and that's where we started. I will say, though, that some of the UL products that have been developed since then have sort of degenerated, and we do have a problem. That's why we are working with this revision of the non-forfeiture law. Problems have arisen from the variations in UL that have occurred since that time.

MR. GILL: John, may I ask you if you recall what happened to the Greeley initiative on a no-cash-value policy?

MR. MONTGOMERY: The sub-committee investigated it, and, as a result of some survey they made of the Canadian experience at that time, they came to the conclusion that they couldn't support it. I don't know that, if it were opened up again, the same conclusion would be arrived at. But, at that time, it died because they didn't believe that the no-cash-value policy would generate enough premium differential to be worth the effort.

MR. MILLER: The ACLI Actuarial Committee did take a look at that. I don't clearly remember what the estimates were in terms of premium reductions that could be achieved by eliminating only cash surrender values and keeping paid-up values; my best recollection is that they thought maybe something like 15%. Their judgment was that in the real world that was probably not enough of a reduction -- that not a lot of companies would really want to pursue such a basis, so why bother with the time, effort and energy that is associated with pushing for any change in legislation as basic as a standard non-forfeiture or standard valuation law?

It is mentioned in our report that a proposal was developed by several companies with the aid of a consulting firm to permit policies with neither cash surrender values nor non-forfeiture benefits. That proposal has been given a fair amount of circulation, presented to John's NAIC committee and so on. One of the arguments that this group advances in support of their position is that in their belief very significant premium reductions are possible.

MR. MONTGOMERY: It would seem that from that proposal it would encourage some form of rate regulation on such policies. I don't know if we want to go into that.

MR. ROBERT J. POLILLI: I would also add to the comments about the auction value being a bad idea for lack of insurable interest to the policyholders. Also, my past experience in the biggest problems I have seen with regulators has involved agent conduct and lack of expected cash values in the policies from the policyholders. With that background I question not having cash values. But I would also like to ask a question: the Canadians do not require cash values; have there been any market conduct problems in Canada?

MR. MCCARTHY: From the beginning I was not a fan of the auction value approach, but I think it is important to clarify part of the way in which the committee looked at it -- it did not necessarily contemplate writing a policy which said that when you want to get cash out of this policy, go out and find somebody to buy it. Rather, the policy would prescribe a method of calculation of value that would simulate what a market might be like. That has its own problems. I was not for that either, but I emphasize that the catch phrase "auction value" as used in the report did not, in my judgment, mean "go find a market." It meant "find a way of calculating a value that would behave as though there were such a market."

MR. MILLER: I can tell the group the little bit that I know about developments in Canada. It is true that products without cash surrender values are permitted there. The most common name for them is term to 100. Some of them have provided paid-up non-forfeiture benefits -- others do not. There has been a significant degree of concern expressed by the Canadian insurance regulatory authorities about these "lapse supported" products (their phrase). They were concerned about whether some of the reserving levels that seemed to be emerging depended too much on the company's ability to actually experience certain levels of termination. They asked the Canadian Institute of Actuaries to come up with some reserving guidelines. That was done. I can't tell you much more about what, if any, real impact it's had on the market for these products in Canada or what current experience is. I observe, in line with John's comments, if it has turned out that the new reserving guidelines have caused a general rise in the level of required reserves, then it's possible that that could have some sort of effect on premium rates for these contracts.

MR. R. STEPHEN RADCLIFFE: I wonder with regard to the recommendation that we possibly institutionalize economic adjustments in our standard non-forfeiture law whether you discussed any of the practical problems of regulation as a security of our products.

MR. MILLER: The answer is that we did. We did not have a securities lawyer on the group and we did not try to form a conclusion, but we did think two things:

1. Concern about the possibility of such regulation was one of the reasons why we said that we did not contemplate that companies would be required to include such adjustments; and

2. We tried to describe our concepts of the adjustment in such a way that it would not be directly related to a particular pool of underlying assets.

It could be index related in the manner that variable loan interest rates are indexed. We don't think we've explored that fully -- we think there is some potential for a mechanism that might avoid securities regulation but we would not propose that it be universally prescribed:

1. There are strong marketing reasons against that; and
2. A company shouldn't have to take on that regulatory issue if it doesn't want to.

MR. JOHN K. BOOTH: Most of Walt's comments have summarized what I found. Basically, there is a risk. Since we are talking about a non-forfeiture law and what companies are permitted to do, they are coming down aside of saying, well, companies should be permitted to have the economically adjusted cash values if they want to, but each company is going to have to work out on its own with its own securities lawyers and experts how it might design a product that hopefully would escape SEC regulation.

MR. MILLER: I would like to take this opportunity to underscore the committee's feeling that since we believe that if there is any such market value type adjustment it should not be mandated, there is therefore a necessity for any emerging non-forfeiture legislation to adequately recognize the cost of providing any cash surrender value guarantees on a book value basis.

MR. DONALD R. SONDERGELD: I have two points I would like to make. One relates to the theoretical basis. The asset share basis seems to me to be an inappropriate theoretical basis. The market value of the asset share should be the appropriate theoretical basis. Permission should be granted to deviate from that theoretical basis if a company so chooses. Looking at the report, it seems like it is just the reverse. You look at the book value as the theoretical basis, but you can go to a market basis. It just seems backwards to me though I don't disagree with the two approaches.

The other comment I would like to make relates to the recommendation that adjustments should not apply to non-forfeiture values. Does that mean once the cash value has been determined, then the insurance non-forfeiture benefit would be based upon either the adjusted or the unadjusted cash value, depending upon which it is, or does it mean you use an unadjusted cash value to purchase the insurance non-forfeiture benefit?

MR. MCCARTHY: The latter, Don. On the theory that the cash isn't all going out at once.

MR. SONDERGELD: But if the cash were to be a given to another insurance company to make the payment, for example, it would seem to me the adjusted amount is the amount that is available and needs to go out of the insurance company to purchase this benefit from another insurance company. I think I disagree with the suggestion.

MR. DOLL: Dan mentioned earlier the joke about schizophrenia and, to some extent, this task force has suffered with that a bit. We are a task force on non-forfeiture principles. One comment was made earlier that we haven't provided actuarial equity if we don't have cash surrender values equal to non-forfeiture values. I think you can make an argument that the asset share is an actuarial equity value that we can address as far as non-forfeiture values. Then the point can be made that by offering paid-up values, we have provided that value to the policyholder.

Do we also need to provide cash surrender values as well? Once we start getting into the realm of cash surrender values, we are crossing over into the area of practicality where it was not obvious that we had a clear charge. It may very well be that we are not going to get a consensus on this task force on the issue of cash surrender values. The best that this task force might be able to do is to say here are three different ways you might approach it and any of those three ways might work in a practical sense. Eventually the regulators are going to have to make a decision as to which of those approaches they want. Once an approach or target value is picked, then an actuarial committee can do its best to come up with methodology to produce that value.

MR. FORREST A. RICHEN: I have a question for the committee on the point of required cash values. Has the committee addressed the question of conditional crediting of values? Paid-up additions, for example, are generally regarded as guaranteed once they have been credited. The same is true for many UL products, but I think I have seen somewhere a conditional crediting of value. Because you have gone to the retrospective approach and because you have combined principles with practicality, it would seem to me that you would almost have to address smooth progression of cash values if you are going to do something that is adequate in dealing with this question.

MR. DOLL: We have discussed that. For non-forfeiture values, the smooth progression is a consideration and on cash values we still have a range of opinion. You didn't mention it specifically, but I would think that these persistency bonuses on UL that we are starting to see raise some non-forfeiture implications from a theoretical and, springing from that, a practical point of view.

MR. MILLER: The ideas that you get when it becomes known, at least in some quarters, that there is a committee trying to take a "zero based" approach to addressing these issues are interesting. We got one letter from an actuary that said that he hoped that we would recommend permission of what he called the window approach, where cash surrender values would be available for specified intervals of, say, one month during every five years, or something like that. His argument, which bears some consideration, was that if you could find policyowners willing to accept such restrictions, they would be able to get much better value than the kind of policies that are permitted now, because the companies would obviously be able to adopt aggressive investment policies. When you look at the whole world here, there is a very wide range of possibilities to consider.

MR. DOLL: Something else I would like to hear comments on is do you really want regulations or new non-forfeiture legislation to address all these? For example, the issue of persistency bonuses may have non-forfeiture implications. Do we really want statutory regulation or would we rather have actuarial standards to address that? Maybe parallel with the proposal to change the actuarial opinion for valuation of statutory statements should be considered the proposal to have the actuary give an opinion as to whether cash flow testing should be performed. The American Academy of Actuaries will come up with standards on that. Something perhaps like that is what we should be working towards for determining whether a policy has adequate non-forfeiture values.

MR. ALBERT E. EASTON: One of the reasons why I think maybe it would be a good idea to have cash values that are linked to non-forfeiture values is that, as a practical matter, if the committee recommends otherwise, I think that you'll just wind up with a proliferation of different state regulations where one state will say it is a good idea to have them linked somehow, and another state will say they don't have to be linked. We already have seen some of this in state interpretation of existing "standard non-forfeiture language."

Another area that I would like to comment on -- it has been suggested from time to time that policies should have cash values that depend on the prospective health of the insured. As a matter of fact, there are a couple products like that that are already being developed. I think that this kind of a non-forfeiture benefit or really a kind of insurance benefit is more directly related to the auction value concept but as long as the asset share approach produces only minimum values, I think a product like that could also be used in the asset share approach.

MR. DAVID J. HIPPEN: One thing at least needs to be considered in determining whether there needs to be mandated cash surrender values in non-forfeiture benefits; it strikes me that in the replacement market, a lot of what's done is taking cash values from the existing products and rolling them over into a new policy, and that's what makes the relatively higher premium of the new whole life or UL product a little easier to take. I think we might be creating an interesting situation if all that's allowed is non-forfeiture benefits. A relatively healthy person might get less value for his existing policy on replacement than an unhealthy person. It might indeed create some secondary market in replacement cases.