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STATUS REPORT ON STANDARD NONFORFEITURE LAW REVISIONS

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o The panel will discuss the revisions to the standard nonforfeiture methodology as proposed by the Society of Actuaries' task force on nonforfeiture values. Items to be discussed include retrospective versus prospective methodology, no-cash-value whole life, rate regulation issues, and market value adjustments.

MR. DOUGLAS C. DOLL: All three of us are members of the Task Force on Nonforfeiture Values. The purpose of this session is to give a status update on where this task force stands. Last fall in Boston we presented an interim preliminary report giving some initial conclusions of our task force; and then, we went on to say from that point forward, now that we had agreed on some of the underlying principles, we were going to start working on some methodologies to implement those principles.

Our task force is now at the stage where we have some methodologies we are trying to choose among. We have to do that soon, because we are expected to give a final report in the next few months. This is a chance for us to give a status report on where the committee stands and a chance for you to give some input as to which of the alternative methods you think that the committee ought to give special weighing to.

Walt Miller, as chairman of the task force, will spend a few minutes giving some background of the task force, telling you where we have gotten up to now; and then, the balance of this session will be devoted to Dan McCarthy and myself discussing the issues. We are going to leave plenty of time for audience participation after each of those issues.

MR. WALTER N. MILLER: I would like to underscore what Mr. Doll said about our desire, if not eagerness, for input from you. There are a lot of things going on in the Society, Academy, and the Actuarial Standards Board (ASB) that are important developments on issues that are critically important to the businesses in which most of us are engaged. One of the things that we continually see is lack of input. We know a lot about actuaries' special skills and special qualifications to comment on most of these important issues, but we do not hear a lot of comment. This does not help make real progress on a lot of these issues, and, honestly, it doesn't help the profession very much. So, please, listen to whatever we have to say, take it with a healthy grain of salt if you wish; but the most important thing is tell us what you think, and where we should be headed in an effort as important as coming up with the next generation of nonforfeiture legislation.

I am going to start off by briefly summarizing the executive summary of the interim report which Mr. Doll mentioned that our committee developed just before the annual meeting of the Society in Boston last year and discussed at that meeting. As you are about to hear, we made some interesting and significant progress and have drawn tentative conclusions on some important points and recognize that to a certain degree, there are still many pros and cons and many alternatives on some of the others.

The first of these tentative conclusions is that there is no theoretical actuarial reason for requiring guaranteed nonforfeiture benefits. However, given the historical and regulatory context of the insurance industry in the U.S., nonforfeiture benefits should continue to be mandated, a concession the committee perceived as a political reality. An additional observation we made is that, if there had been a well-developed and objective auction market for life insurance policies in existence in the U.S. at the time, many of us might have come to a different conclusion, but we did not see that market.

What we did see a couple of months later (some of you may have heard about it) was the formation of a company that has announced that it is in business to buy the policies of terminally ill people. Reaction to that has ranged from a bit of applause in some quarters to one prominent commentator characterizing it as a system for exploiting the terminally ill. You can take your choice on that position, but the committee continues to feel that some form of nonforfeiture legislation is going to continue to be necessary. We think that whatever principles of actuarial equity are applied, they should be applied pretty well across the board to all types of life insurance policies to which this legislation might apply, as well as to annuities. We thought that, like the basis of current nonforfeiture legislation, an appropriate methodology to measure amounts which might be required to be accumulated to provide minimum nonforfeiture benefits, the so-called asset share approach, was and still is an appropriate method.

We do feel that, although some level of minimum nonforfeiture benefits should be mandated, a level of minimum cash surrender values should not be mandated in every single case. On that point there has been a fair amount of discussion. The committee currently finds itself in general in favor of permitting the so-called no cash value type of policy (or Term to 100 as it is called here in Canada) as long as there is a nonforfeiture benefit. We had not then and have not yet reached a consensus on exactly what minimum cash surrender values standards should apply if a company elects to provide cash surrender values. There are some people on the committee who felt then the company should pretty well have free rein. There were others who felt various levels and approaches to setting forth minimum cash surrender values should be applicable to companies that decide they want to provide those values.

We did feel that the concept of market value adjustment should be embodied in an appropriate way in minimum cash value legislation if that area is covered. One other thing, in determining if there is to be any minimum level of cash values there is one concept that affects companies significantly that we do not think is embodied in current law and should be embodied in any revision. This is the concept of providing capital guarantees (providing free cash out privileges to your customers, if you will) regardless of the condition of the company's assets or the money markets at that time. This is a privilege to companies providing such guarantee that can be very significant, and this should be recognized.

MR. DOLL: When our committee started deliberations, I think most of us, if not all, thought that we would end up with is some sort of retrospective type nonforfeiture methodology. Universal life seemingly requires a retrospective approach, and we could take traditional products, break them down from their current structure into a retrospective structure. However, it has not worked out that way. Coming up with a retrospective methodology has been difficult. Now we are back to a debate between retrospective versus the prospective method. Mr. McCarthy is going to present the retrospective point of view, and I am going to present the current status quo. I would like to call this presentation "If it ain't broke, don't fix it."

I will readily grant that the theoretical equitable value for nonforfeiture is the asset share, which is a retrospective value. It is the amount of funds that the company has after it accumulates the premiums and interest, takes out the charges for mortality, takes out charges for expenses, and takes out a risk and profit charge. However, a retrospective nonforfeiture formula, unless the parameters exactly equal the company's experience, is not going to reproduce the asset share. In fact, if the parameters are different than actual experience, you are going to diverge from the asset share. Think about a premium accumulating at, say, a mandated 3% interest rate if your actual interest rate is 5%. The differential at the end of year 1 is 2%; at the end of year 2 is 4%; and the differential is going to grow and grow. You might think that is fine. That means my minimum values are significantly less than what I actually have. The problem is, if you are going to regulate these parameters, what happens if the regulation goes the opposite way? What happens if the parameter is more than what you are earning? Then, you are just going to get farther and farther away from what the actual value should be.

In my opinion, the only way a retrospective approach could work would be if we got away from having the regulators specify the parameters; and instead, put the responsibility strictly on the actuary to determine what equitable value should be, a situation analogous to what they have in the U.K. where there are no minimum nonforfeiture values. The actuary can determine what the minimum values are. This probably would require the regulators to accept an actuarial opinion and require the ASB to develop standards of practice. I think it is a workable solution ultimately, but there seems to be very little sentiment in favor of it. None of the actuaries I speak to in

crowds such as this jump up and say, "Yes let's do this!" and the regulators do not seem inclined to embrace this idea either. (Even though, they are going at least partially that way on the valuation actuary concept.) The only other way you can have a retrospective formula is to have the regulators control the parameters, and that takes us all the way to rate regulation. If you are going to control the parameters, you are going to have to control all the parameters including expenses. Otherwise, the clever actuary will find ways to beat the system. So, I don't believe the retrospective approach is a very satisfactory way to address nonforfeiture, but why does that mean then that the current nonforfeiture methodology is any better?

I would like to explain how the current nonforfeiture methodology works. The most common perception seems to be that the current methodology is prospective. If you look at the mechanics, it is prospective -- present value of future benefits minus present value future adjusted premiums. In reality, that prospective methodology was just a methodology to accomplish a goal, and that goal was as follows: minimum values somewhere close to, but not higher than the asset share. The people who created it said, "We know what the asset share is at issue of the policy. It is a negative amount equal to the acquisition cost of the policy. We know what the amount is at maturity of the contract. For whole life policy, it is $1,000 per unit. All the Standard Nonforfeiture Law does is grade between that negative amount at issue to the $1,000 at maturity." We have this formula that prescribes a mortality basis and interest basis to grade from one point to the other, but we shouldn't pay a great deal of attention to the actual size of the parameters themselves. The committees that developed standard nonforfeiture laws in 1941 and reviewed them again in 1975 looked at the values produced compared to some actual asset shares that they calculated, and noticed that this produced reasonable values, so it is a good methodology. But, they did not really intend that one focus narrowly on what the parameters are.

There has not been to my knowledge a great outcry from actuaries or regulators saying that the current Standard Nonforfeiture Law does not work well for traditional plans. Instead, the reason our task force was formed was because of a presumed inapplicability of the Standard Nonforfeiture Law to flexible premium universal life. There was a secondary issue, the fact that the nonforfeiture law does not cover nonguaranteed elements, which we will address later in this session. The problem with applying the Standard Nonforfeiture Law to universal life is that because we have flexible premiums, we also now have flexible benefits, and we can't do our grading. Oh, we might be able to figure out what the asset share is at issue, but we do not have a maturity value we can key on. There are a couple of ways that we can get around the problem. One is to test it on some designated premium pattern. One premium pattern we might choose is the level annual premium that will mature the contract at maturity. For universal life that matures at age 95, what level premium will get you on a guaranteed basis to $1,000 cash value at age 95? We could test the Standard Nonforfeiture Law on that premium basis. It is a straightforward calculation. We have called this the guarantee maturity premium test, or the GMP test. Perhaps, we could let that be sufficient or perhaps the actuary's product filing could demonstrate that the GMP test works and make a statement that significant distortions would not occur under other premium patterns. Then, we would have to define perhaps what significant distortions are.

The GMP test has been suggested before. This is not a new concept. Many of you might be aware that regulators have made several proposals to modify the Universal Life Model Regulation over the past few years. The latest proposal actually had the GMP test included in it, but it also had a number of other proposals in it, mostly related to regulating what I call the benefit generating function, that is, the parameters of the universal life fund value accumulation.

I believe that the GMP test, by itself, is sufficient to satisfy the spirit of nonforfeiture that is in the Standard Nonforfeiture Law. I do not think it is necessary to say that mortality charges in a universal life policy should not exceed 100% of 1980 CSO. I think if we start limiting those parameters, then what we are doing is not trying to satisfy nonforfeiture principles, but we are trying to satisfy other goals and objectives. I can't apply a label to it, but I think from a regulator's point of view, there is a desire towards disclosure to the policyholder and having the policyholder get what he thinks he is getting when he buys the universal life policy. I think there is a feeling that if you have very high mortality charges, the policyholder does not understand; and therefore, we need to regulate that, but that is an issue over and beyond nonforfeiture. Nonforfeiture is just saying, let's make sure that we have a value that is consistent with the asset share; let's grade appropriately from the initial value to the maturity value. You can do that in spite of charging more than the 1980 CSO mortality.

However, I think our task force is probably going to concede that there is strong interest in regulating certain components of the benefit generating function for universal life; and although we will make the point that is not necessary for strictly nonforfeiture, that is possible to do things like regulate the maximum size of cost of insurance on universal life. I believe that in the interest of disclosure, equity, or whatever you want to call it, it is probably appropriate to say that the maximum surrender charge should not exceed an amortized version of the initial expense allowance. We could devise a benefit generating function such that the account value minus a very, very large surrender charge still produces nonforfeiture values that exceed the minimum under our definition of what minimum should be. On the other hand, if you do allow such surrender charges, the policyholder probably will not be fully appreciative of what that surrender charge is. Again, I think we are going to have regulations focused less towards absolute nonforfeiture values and more towards just having a reasonable result.

Finally, I just would like to make a small pitch for the "mystique" of whole life. If we come up with a retrospective approach for nonforfeiture, then we are hastening the viewpoint that life insurance, no matter what kind is nothing more than term insurance plus a side fund. I think the industry has some vested interest yet in keeping the impression that there is more to it than that. It is not just term insurance plus a side fund. If it is strictly term insurance plus a side fund, then we weaken our arguments for favorable tax and regulatory treatment.

In summary, I would like to give reasons why I think we should keep the current Standard Nonforfeiture Law and simply to add the GMP test. First of all, I think the current methodology is a good method to approximate equity between persisting and terminating policyholders. I think that retrospectively using the parameters in the current Standard Nonforfeiture Law is a way of taking the Standard Nonforfeiture Law and trying to apply other objectives, namely rate regulation.

A retrospective formula with specified parameters does not necessarily equal asset share values and, therefore, does not achieve the primary equity goal. A retrospective formula is going to be too restrictive on product design; and if it is not too restrictive on product design, then it is going to be of the form that a clever actuary can beat. A retrospective formula is going to be disruptive to current traditional plans. I think adding the GMP test adequately addresses universal life. This is a point that we will talk more about later, but guaranteed nonforfeiture values are somewhat irrelevant now with the advent of nonguaranteed elements on products, so I fail to see why we need to make significant changes in the way we regulate guaranteed minimum values if nonguaranteed values are the real issue. Finally, it seems that the IRS is doing a good job of regulating rates, so maybe we need not have the states involved with this also.

MR. MILLER: While Dan is approaching the podium, I would like to make just one comment on what I believe is a theme underlying several things that Mr. Doll correctly pointed out about regulators' perceptions and their attitudes. One of the things that actuaries are perhaps uniquely qualified to see is that in many cases the whole isn't the sum of the parts. In many cases, it does not matter how you got there, the important thing is where did you get and how is that going to work out in the real world? Those are very valid concepts, but very often regulators find themselves in the position where they can't buy in to just one overall final result. Example, disclosure, where it is possible to say, I think correctly, how many rules and subillustrations and special policy summaries do you really need to have? All you really need to do is show the policy owner what they are going to get in terms of death benefits and cash values for a specified level and incidence of premium payments. Regulators cannot quite see it that way and continually come up with proposals that multiply the amount of paper that has to be produced. An example is, Mr. Doll's observation about how the current Standard Nonforfeiture Law at its root really provides a grading between minus the initial expense allowance at issue and the maturity value at the end of the lifetime of the group of policies. True, but regulators really do feel compulsions to recognize the fact that the public is going to perceive some of the pieces of how it gets to be that way, like mortality charges. The regulators have to feel that they have to react to some of these things.

MR. DANIEL J. MCCARTHY: I had not planned to begin this way, but I must start by saying that only an actuary would think of, as a reason for defending anything, preservation of the "mystique" of whole life. I am really impressed by that. I am particularly impressed, because just two hours ago next door I heard Doug say that people are devising products that are breaking down the mystique of whole life while retaining the name.

Let me say that it is very ironic that I was asked to speak about the benefits of retrospective methods of establishing minimum nonforfeiture values. The reason it is ironic, and we could not have known this when we established this program, is that two weeks ago at the last meeting of the task force, I proposed -- and have since proposed in writing -- that the task force abandon all efforts to develop a workable retrospective method and in effect do essentially what Doug has suggested. However, there is probably still justification for my speaking to you on this point, because the reason for my suggestion was not necessarily that a retrospective method would not be appropriate or even superior, but just that the particular bunch of people we have on our task force has trouble agreeing on anything. Our group is less likely to agree on a new method that would be a departure from what is being done, than on an extension to what is being done. I think that Mr. Doll has properly described the guaranteed maturity premium as an extension of what is done.

I found it interesting that, when Mr. Miller was reading his summary of things in our tentative report last fall, he left out one section. I am sure the reason he left it out is that we have since said that we are probably going to go a different way. If you get that summary, and look at point 5, you will see that point 5 at that time said, "The minimum paid-up nonforfeiture benefits should be determined by a retrospective method, and its value should converge to the maturity value of the policy, if any. The task force is studying alternative methods which achieve this end." The task force did in fact study alternative methods to achieve that end. We will talk about two of them in a moment.

In thinking about these methods, it is important to focus on something else Mr. Doll said which is the reason why this effort got underway in the first place. The effort was formed not because regulators were unhappy with the state of nonforfeiture values for traditional fixed premium, fixed benefit contracts, but rather because they were unhappy with flexible premium/flexible benefit contracts. I think it is fair to say that at the time this task force was formed, that unhappiness was not precisely focused. That is to say, nobody gave us a list and said, here are seven things we do not like; please fix them. There was kind of a malaise hanging out there, and that has led us to explore a number of ways to develop workable nonforfeiture and related rules.

Mr. Doll properly pointed out that it isn't just nonforfeiture for flexible premium contracts. We are trying to have one consistent methodology that brings together both fixed premium/fixed benefit and flexible premium/flexible benefit contracts. If we don't do that, lots of actuaries would be smart enough to explore all of the nooks and crannies and develop all kinds of unusual looking products to make their product fall into the particular corner that gave the best advantage to it. Everybody seems to think that is not a good idea.

Retrospective methods have a certain natural element to them when we are talking about flexible contracts. That is to say, when you have a contract which is explained to the customer as an account value into which premiums are paid, to which interest is credited, from which charges are made, you have just described a retrospective concept. In fact, that is probably the reason why the Standard Nonforfeiture Law for annuities follows that retrospective notion. It may not have a mystique to it, but it is understandable. That is what tends to lead one down the road of saying at least, "Can we make this thing work?"

Now, in thinking about retrospective methods and how they might work, our committee essentially explored two. I tried to think of an appropriate pairing of words to describe them, and I really did not like any of the pairings that I came up with, but I will call one pair "open and closed" or another "restrictive and nonrestrictive." The open or nonrestrictive approach is one in which you specify a retrospective method, but you do not specify values for all of the parameters. In a particular illustration you may indeed specify maximum mortality charges; you may indeed specify a minimum interest rate; you may indeed specify a maximum initial expense allowance; but, you do not specify a maximum level percent of premium or per thousand expense that could be taken in all years. That is, after all, what we have in the case of traditional fixed premium fixed benefit contracts. We have a specification of a mortality charge. We have an interest rate limitation. We have an initial expense allowance limitation. Because there is no limitation on the overall gross premium, in effect, a company can build in whatever load it likes.

One way to begin exploring is to say: Let's take that same concept; let's limit everything except the level expense allowance that could be built in all years; and let's do it retrospectively. If you do that, what you really find is that you have created an awful lot of work for yourself

converting fixed premium fixed benefit contracts into that form and making everything work. In the end you really have not done that much. You haven't done very much because you have allowed, through this mechanism of an unlimited level expense load, a company to charge whatever it would like to charge. You may have achieved some limitation on the size of a surrender charge, but you have not achieved anything which really regulates. You have not done anything that really produces a meaningful grading of nonforfeiture values.

That leaves one naturally to explore the other alternative, which is, in effect, the alternative that is used in the annuity nonforfeiture law, which says, "If we can't get anywhere except by specifying everything, let's specify everything." If you specify a maximum mortality table, if you specify a minimum interest rate, if you specify a maximum first-year expense allowance, and if you specify a maximum annual expense allowance, you have indeed specified everything; and you could calculate, via that means, minimum nonforfeiture values.

If you do that, there is one other thing you need to think about, particularly if you want to build traditional products into this structure; and particularly I might add, if you want to build traditional participating products into this structure. You need to provide some way in which a company selling participating products can build in a dividend margin. There is a way that one can do that. The first time I saw it proposed was a little over 20 years ago in the original New York life design of variable life insurance in which it was proposed that a fixed percent of premium dividend margin be built into the policy. If that kind of analysis were followed here (if a company was allowed in selling a par product to build in a margin in order to be able to reflect cost over time), there would then almost as a necessity be a related requirement that somebody opine over time that the extra loads that have been built into that contract are in fact being used for policyholder benefits one way or another. That is an issue that I think you have got to deal with if you are going to explore a totally specified retrospective method.

By and large, as Mr. Doll pointed out, people have not been fond of totally specified retrospective methods. It is really kind of peculiar in a way, because they are springing up all over the place. The SEC has one, and people live with it for variable life. The IRS essentially has one, and people are kind of inching toward it for tax purposes. There has been a feeling that if this "parade" isn't going anywhere, let's not try to lead, and that is probably, more than anything else, the argument against trying to adopt a fully specified retrospective method for all life products despite the fact that it exists for annuities, and despite the fact, by the way, that it might be a very good fit to things like long-term care products and other kinds of account value driven products. It may be, in other words, that time is not here yet, and that is why I proposed two weeks ago that we stop working on it for now.

However, I would venture that if we were having this particular discussion in 10 or maybe even 5 years, we may find that we will be looking at it in a different direction. Perhaps, the time isn't there yet, but nonetheless, I think we are going to find over time that there will be more pressure, regulatory and otherwise, for a fully specified method of calculation of nonforfeiture values. I suggest to you, given the products that the industry is moving towards and notwithstanding the "mystique" of whole life that a retrospective method of description is one that I think is understandable to the regulator and the customer, and one that I think some day will be with us.

MR. GLENN A. TOBLEMAN: I tend to favor Mr. Doll's approach, primarily because it is a very convenient, easy way to prove while you are developing the product that the nonforfeiture values are going to meet the test. One thing, I think, has been addressed before but I would like to know what the status of it is. What about smoothing requirements, particularly on universal life products that have bonus features where the tenth year cash value might jump higher than the ninth year? What is being done to address that?

MR. DOLL: First of all, the smoothness test, for those of you who are not familiar with it, in the nonforfeiture law requires you to grade cash values over at least a five-year period. It was put in there as a way to prevent deposit term insurance policies where you had policies that went for nine years, then you had a large tenth year cash value. On universal life insurance, if we do this GMP test, and we are testing what the guaranteed values would do assuming that we paid level guaranteed maturity premiums, we could apply that smooth cash value test just as we do now for traditional plans. What that would mean is that you could not have a surrender charge that had a "cliff" in year ten where you had the maximum surrender charge for 10 years, and then immediately went to zero. It probably would require surrender charges to grade off over a five-year

period. You also raised the issue of persistency bonuses. The guaranteed persistency bonuses would also have to be graded in over at least a five-year period. Nonguaranteed persistency bonuses are another matter. The Standard Nonforfeiture Law right now does not have any requirements for nonguaranteed elements.

MR. CHARLES E. RITZKE: I, too, agree in principle about Mr. Doll's prospective approach being the most appropriate. One concern I would have is the elements of the benefit generating function. When you start talking about regulating elements of benefit generating functions, it is important also to find a benefit generating function for traditional products and regulate the same functions and the same pieces in order to maintain a level playing field. One example would be when you are talking about defining that level expense element. When we are designing a universal life policy we can have, theoretically, any expense level we would like, but one thing we can't do is price it appropriately for smokers, because we can't vary the level expense between smokers and nonsmokers. Whereas, the way things are currently defined, we have complete freedom to do that on the traditional policy, so there ends up being discrepancies and inconsistencies which seem to cause a lot of problems.

MR. MILLER: I think the admonition to do our very best to create a level playing field all the way across the product spectrum is a good one, and it is one that the committee has been very mindful of throughout the course of its checkered career. Our ability to work out a solution that fully addresses that issue is yet to be seen, but it is a good point.

MR. DOLL: One thing to keep in mind is that you can take a traditional whole life policy and determine an underlying benefit generating function, because the cash values are simply there. You can fix one item and say, "We are charging 1980 CSO mortality and 6% interest," and then solve for the effective nonforfeiture net premium. I think one state allows mortality charges to exceed 1980 CSO if you take the excess and call it an expense charge. Even though it is the same dollar charge, it is just labeled a different way.

MR. MILLER: I think your example of smoker versus nonsmoker pricing is one illustration of several that could be offered that goes by way of breaking down what we use to think of as sort of a monolith of standard risks who are presumed to be 96% of all policies sold. You charged them all the same thing, differentiating only by age. What we have seen is considerable subdividing of that monolith -- smokers and nonsmokers, varying degrees of guaranteed issues, simplified issues and a host of others, and it has certainly made any concept of specifying mortality tables more complicated to do. That is not saying that people are not trying, and I suspect the natural tendency is to continue to try, but every time we keep trying, classifications spring up. Therefore, I think that is an area that has a way to go yet before you know how it is going to be resolved.

MR. RICHARD E. ROWAN: I think the point about having total freedom for the annual expense charges is a little bit of a misnomer. Yes, we do have freedom on that. Our contracts of traditional products make a statement as to a guarantee of what that will be explicitly, because we have a guaranteed premium. It could vary within the marketplace. With any regard to a universal life product you can compare that fairly well to a traditional par product. You have a guaranteed benefit generating function, and you have an actual benefit generating function. At some point you accrue the difference to the policyholder's benefit in a traditional product that comes in the form of a dividend which may be applied to purchase additional insurance in one way or another. It seems to me that the matter is the accrual of the difference between the actual and theoretical basis. We can regulate a theoretical basis. The problem is when do you regulate the accrual of the difference between the actual and theoretical?

MR. MILLER: That is a good way for us to get into the next portion of our program. Persistency bonuses are supposed to be new and on the crest of the development wave of nontraditional products. When I first came into the life insurance business in 1951, I worked for a large mutual company that had a relatively unique, but well accepted, dividend system. It had regular annual dividends, and then on most permanent plans the company illustrated and paid so-called extra dividends -- $5 per $1,000 -- at the end of the tenth year, $10 at the end of the fifteenth year, $20 at duration 20. The company abandoned that system in 1954 in response to what it felt were competitive pressures to raise the level of annual dividends. That is a good illustration of the fact that there is often less new under the sun than you might think.

It is true that now there is a proliferation of product design elements in the so-called persistency bonus family. Some of them are guaranteed, and as indicated before, a very significant question in the case of guaranteed persistency bonuses of one form or another could be to what extent, if any, should the smoothness requirements in the current Standard Nonforfeiture Law be carried over into the next generation of this law. Equally and perhaps more important (because as Mr. Doll indicated it is not dealt with in current regulation and it is something that a lot of regulators are getting very nervous about) is to what extent if any should nonguaranteed persistency bonus elements of various sorts be dealt with in the next generation of Standard Nonforfeiture Law?

MR. DOLL: This is a situation where I do not think we have committee agreement. In fact, I have a proposal that so far seems to be a proposal of one. I want to talk about nonguaranteed elements.

We have two issues to address on nonguaranteed elements. Persistency bonuses are one. That is the one we will spend the most time on. The other one we call the issue of take-aways. One of the things that the regulators have expressed to us is their discontent with the fact that you can credit excess interest to a policy or charge a mortality charge less than the guarantee. Yet, if the policyholder tries to surrender after that point, the cash surrender value might still be zero, or at least the cash surrender value is affected by the fact that excess credit was impacted by the surrender charge. Policyholders want these credits viewed as dividends that, once credited to the policyholder, should be over and beyond the basic workings of the policy and should be available to the policyholder under all circumstances. We have a pragmatic solution to that.

First of all, recall that the current universal life model regulation allows in addition to the regular surrender charge which is the balance of any initial expense allowance that you have remaining, 12 months excess interest. We believe as a practical compromise, that take-ways of amounts that have already been credited should be allowed, but only to the extent that there is an amount remaining of the initial expense allowance. If you have some initial expense allowance remaining in the policy, you can have an excess interest surrender, but only to the extent that you have some amount of this remaining. We think it is okay to have a universal life policy with the surrender charge larger than the first year premium, so you credit some excess interest in the first year, but the cash surrender value can still be zero at the end of the first year. I think that is purely a pragmatic recommendation.

Let's talk about persistency bonuses. First of all, I think we can all agree that there is an issue here. I would like to think we can all agree there is a problem, that is, the fact that we have no regulations on nonguaranteed elements, meaning that nonguaranteed elements can be skewed towards the later durations of a policy, i.e., persistency bonuses, which violates the principles of equity that we have in nonforfeiture. There are no actuarial standards right now requiring equity between persisting and terminating policyholders in the determination of nonguaranteed elements. I made a proposal at our last committee meeting which we discussed. The reaction was fairly negative, but I am going to present it again. My proposal was that we prohibit the illustration of nonguaranteed elements if not reasonably supportive by projected earnings in the year that nonguaranteed element was credited. Note that this would not influence what the company actually credits. Credit whatever you want. We are saying we are not going to allow you to illustrate in the future, amounts that are not supported by the earnings in that year.

Let me spend a few minutes to present the background on regulations of nonguaranteed elements. First of all, let me explain why I mentioned earlier I think guaranteed minimum values are somewhat irrelevant. I think all you need to do is, for a universal life policy, compare the guarantee maturity premium to the premium using current interest and current mortality charges, and you will find there is a significant difference. That difference is the amount basically that you have available that, if you wanted to, you could defer and pay off at some much later duration -- e.g., duration 20. The amounts could be very substantial. I was talking about the difference between current and guaranteed mortality and current and guaranteed interest, and we mustn't overlook the fact that there is unlimited potential game playing on expense loads, too. One could have a universal life policy, put in a $10 per thousand annual guaranteed expense loading, but then on a current basis you can actually charge $10 for a few years, then in later years charge negative amounts or actually give credits in that policy. Effectively, you have taken away in the early years and credited it back in the later years. You can construct a very nice tontine if you want to.

I want to talk about some other kinds of policies besides universal life. Let's talk about the regulation of par whole life dividends, indeterminate premium whole life. First of all, par whole life is not "lily white," in spite of a perception that dividends are well regulated. I think it is fairly common to have dividend scales where the expense component slopes to higher dividends in later years than in the early years. It is not necessarily totally related to the actual incidence of expenses. We have seen in the last few years a couple of stock companies introduce participating decreasing term policies where dividends are being used to keep the death benefit level, so in effect you have, on a nonguaranteed basis, a level premium no-cash-value whole life. This must indicate that, somehow, the regulations on dividends can be bent enough to issue a policy that seemingly violates the principles of nonforfeiture equity.

The statutory regulation of dividends dates back to the Armstrong Regulation 1905-1906. If any of you are interested in some of that history, we put that history in our interim report that we distributed last fall. Right now, many states have requirements of annual accounting of surplus and annual disbursement of surplus. We have actuarial standards. We have the contribution principle that doesn't tell you what distributable surplus is, but says you must distribute the divisible surplus among policies in the same proportion that the policies are considered to have contributed that surplus. You have to use the contribution principle or in your actuarial report state the deviations and the rationale.

Let's move on to indeterminate premium whole life, which was popular for a few years before universal life was invented. The NAIC adopted an actuarial guideline, Actuarial Guideline 22, that covers nonpar indeterminate premium whole life. That guideline says that nonforfeiture values for indeterminate premium whole life should be based upon the higher of the values you get from using guaranteed premium pattern or the currently illustrated premium pattern. The reason for that was there were companies that were constructing premium patterns where the guaranteed premium was going up each year. The current premium was scheduled to be level, but if you calculated nonforfeiture values on the guaranteed basis, you would get much lower than whole life cash values.

The authority for this guideline came from the Standard Nonforfeiture Law. Section 6 gives clear statutory authority. The applicability of this section is only for indeterminate premium plans with premiums determined by companies based on estimates of future experience, and it gives commissioners the authority to promulgate a regulation with minimum nonforfeiture values.

I think it is an interesting guideline; because if you were to apply something like that to par whole life and assume the dividends are being used to reduce premiums, we would have much higher cash values than required on par whole life. There seems to be a bit of inconsistency. Indeterminate premium whole life was penalized relative to par whole life, but it was a situation where the regulators took a pragmatic approach. The industry did not complain at the time. Everybody felt like the only reason that you would run into a problem was if you were doing game playing.

We have no current requirements on nonguaranteed elements for universal life. The result is persistency bonuses. Interestingly, several states will not allow you to have persistency bonuses guaranteed, because of the smooth cash value requirements in the Standard Nonforfeiture Law. Therefore, companies are almost forced, if they want persistency bonuses, to make them nonguaranteed. I think we have seen persistency bonuses creeping up larger and larger as time goes on. I think we are going to see them get larger unless and until the regulars step in and restrict it in some fashion.

A few years ago the Society of Actuaries Dividend Committee had an exposure draft which suggested that nonguaranteed elements on a universal life policy or any other policy with nonguaranteed elements should be adjusted or changed only when the underlying experience changed. That exposure draft was exposed at a meeting like this. There was an awful lot of complaint, because the industry felt the actuaries should have no part in restricting the ability of a company to change or adjust its nonguaranteed elements. What I proposed earlier is different. I think we should be able to illustrate any level of nonguaranteed elements we want. I think we should be allowed to change the level of nonguaranteed elements whenever we want to, but I think the pattern of the illustration should provide some equity between persisters and terminators.

I would like to do this with some sort of actuarial opinion or actuarial standard. I do not want to let things get so out-of-hand so that the regulators come up with rules and formulas. I would like to make this similar to the valuation actuary concept. We had a certain set of reserve rules, and then we discovered a new risk, C-3 risk, has to be taken into account. One route we could have followed was to have the regulators dictate formulas for additional reserves. Instead, we are going to a valuation actuary concept where the actuary can use some of his own judgment to determine whether or not "x" reserves are required. I would like to have something like this occur with nonguaranteed elements as well, because I think if we don't do something like that, eventually we are going to have the regulators step in and do something on their own. It may be more onerous than what we feel would be appropriate.

Where can we ask this question about the nonguaranteed elements? Well, we already have annual statement questions on whether or not you can maintain a certain illustration, that requires the actuary to look at the overall support ability of an illustration. So, let's go to the next step -- is the illustration supportable year by year? We can put something else in that annual statement that says the illustrations are supported by projected experience year by year instead of just on a present value over lifetime.

It was mentioned at our last meeting that many states on products with nonguaranteed elements have a requirement that you cannot distribute past gains or make up past losses on a policy. These policies presumably are crediting excess interest on a forward looking basis, unlike participating policies which grant dividends after looking backward at what your past history has done. It would seem like a persistency bonus arguably is one way to distribute past gains on the contract. We have not yet looked into how this fits into those requirements or whether they are even applicable, but it might be another area in which the Actuarial Standards Board could look at a requirement that exists and develop some actuarial standards.

MR. CURTIS H. LEE: I would like to go back to your comments on the regulators' concern over take-aways, and I believe you mentioned they would be acceptable to some extent as long as they stayed within the ranges tied to unamortized initial expense allowances. The concern I had was how that might work with an interest-sensitive whole life product where you may have full fixed premiums and 6% guaranteed cash values and then some surrender charges whose mathematics are tied more to the spread between guaranteed maturity fund and guaranteed account value. If you have some substantial surrender charges in that case, how would that work as far as impact on these take-away questions?

MR. DOLL: Let me direct this question to the audience and see if I get savage here. How would you like it on interest-sensitive whole life, excess interest whole life, whatever you call it, if we make a flat-out rule that any benefit generating function cannot have a surrender charge larger than an unamortized unused initial expense allowance? So, we would not have this game playing that we have now on excess interest whole life where you can actually come up with very, very large surrender charges and justify it because of the mechanics of the contract.

MR. LEE: The fact that we have guaranteed cash surrender values under the fixed premium basis that satisfies this Standard Nonforfeiture Law is somewhat extenuating.

MR. DOLL: Yes, but we have concluded that the equitable basis for nonforfeiture values should be the asset share. If a company has an account value out there, it is pretty hard to argue that somehow that account value is not related to the actual asset share accumulated under that contract. So, I think if you say that somebody can have an account value with all of the account value mechanics and say that you can knock off more than what normally would be an initial expense allowance, it is pretty hard to argue that somehow that is staying within the parameters of what we have defined the equitable nonforfeiture value to be.

MR. MILLER: The regulators have made it clear that they do not like really big surrender charges because they believe, no matter what anyone else says, that big surrender charges are not widely understood, and regulators have more difficulty with a cash value of "x" that is reached by an account value of "y" and a surrender charge of "y-x," than they do with a cash value of "x" that is an account value of "x," and no surrender charge. That difference bothers them as a matter of form.

MR. DOLL: It was suggested within our committee. That we should not permit surrender charges at all. If there is an acquisition expense charge, the company can take a front-end load. The account value, if there is a surrender charge, really has no meaning for nonforfeiture, so we should not permit it. But, that got overridden by a little bit of practicality.

MR. RICHARD W. MATHES: What is the purpose of the expense allowance and what is the purpose of the surrender charge? With interest-sensitive products we have quite a bit of market risk, and, to some extent, people have been using this partially as a proxy to keep people from surrendering so you can invest longer. Taking your logic to the extreme on a single premium product, you have no expense allowance, so the account value would be the surrender value.

MR. MILLER: I think that Mr. McCarthy may touch on that at least in part. I alluded to it a bit up front -- the question of recognition of the C-3 types of risks that companies take when they guarantee cash-out at certain minimum levels. Let's listen to Mr. McCarthy talk for a bit now about the whole general subject of cash surrender values and to what extent, if any, should there be items effecting levels of minimum cash surrender values in the next generation of standard nonforfeiture legislation.

MR. MCCARTHY: The discussions were intended to be focusing on insurance nonforfeiture values. Whatever conclusion you reach as to how you will determine minimum insurance nonforfeiture values, then you are going to deal with cash values. There is a page in the report of our task force of last fall which exhibits a spectacular difference of opinion among task force members on this subject, attributable in part I would say to a set of nontrivial, how should I say, bull moose elements among the task force. The range of opinions expressed in that attachment is as follows:

1. There should be no restrictions at all on setting cash values. That is to say, regulation should focus on insurance nonforfeiture values, but once a company has established them, it can do whatever it pleases for cash values. If you want the cash value to be $1 forever, you can do that.

2. Version 2, which is a variant of Version 1, said there is a requirement that would meet some mathematical definition of smoothness, and the cash values ultimately get to the maturity value. Otherwise, no restrictions. That is pretty clear and pretty wide open. Particularly, since that thinking said in one of its variants, we will prescribe a formula, but we will give the company total freedom as to parameters that go into the formula. That may meet a mathematical test of smoothness, but it has some odd looking results in the extreme.

3. The next variant said, provide for a calculated method for minimum cash surrender values in addition to insurance nonforfeiture values, but that calculation for cash surrender values will not bear any relationship to the insurance nonforfeiture value calculation. In other words, we will approach it from scratch. There will not be any linkage. Linkage or nonlinkage were popular terms in that particular era of our task force.

4. Finally, the most restrictive one said we should have minimum cash values specified except for the zero cash value case, and there should be some linkage between minimum cash values and minimum insurance nonforfeiture values. I will point out to you that in the current law there is linkage. Linkage in the sense that the cash surrender value is the present value of the insurance nonforfeiture value calculated on the basis of a certain mortality table and interest rate.

Recent discussions have been attempting to pull us towards something that we might be actually able to do, but at the same time which recognizes some real problems like the one that Rich just talked about. There are in fact options to a life insurance contract that a customer can use to select against the company. We have been thinking in the following ways. One was mentioned in our report last fall. We would include a mechanism which, if I may use jargon loosely, could be called a market value adjustment. That is to say, if the present value of the insurance nonforfeiture benefit is known, the calculation based on a current interest rate would be used, and this could produce a higher or lower value for the cash surrender value, than for the insurance nonforfeiture value. We have always said that if we build that into our final recommendations it would be built in as an option. A company would not be required to adopt such a method. Among the several reasons for that are some uncertainty or perhaps it is certainty as to what such a

contract would have to go through by way of security regulations, and there is no attempt to foist security regulations on all permanent contracts issued by the life insurance industry.

The other notion we have been developing is this: ideally, what you would really like to do in a theoretical way, is that -- because every customer has an option at any time to take cash -- you would like to have some way to charge for that option, for its mere presence as you are going along. We have had difficulties developing ways that we are comfortable with, making that charge in that fashion without creating a rather remarkable separation between cash surrender values and insurance nonforfeiture values. Frankly, we have not really been willing to live with them, nor have we thought regulators would be willing to live with them.

We are kind of edging towards a two-part proposal that says the following, "If, at a given point in time you know the insurance nonforfeiture benefit and it is calculated by means of a certain mortality table and a certain interest rate, we will allow you for cash surrender value purposes to discount that stream at a higher interest rate, a fixed delta, a fixed difference in the interest rate." You can concoct all kinds of theories as to whether this difference should be one point, two points, or whatever. What that will do is introduce a minimum cash surrender value which is lower than the present value at the stated interest rate of the minimum insurance nonforfeiture value, and that will be true at all points in time.

So, it amounts to saying since we are not going to charge for the presence of the option day by day for all the days that existed, we will allow a company to assess it on all people who actually exercised the option. Is that theoretically perfect? No. Does it at least build in some protection? Yes. The other thing we would do is this. That statement that I just made deals only with minimums. Minimum insurance nonforfeiture benefit and minimum cash values. Many contracts offer benefits higher than minimums. Today, if you offer a contract with nonforfeiture benefits higher than the benefits, you are then dragged up to offer a cash benefit higher than minimum as well. We will allow the same concept of a differential in the interest rate or some other mechanism to apply to the actual nonforfeiture benefits moving there to actual cash values as well as moving from minimum to minimum. So a company that decides to offer more than minimum insurance nonforfeiture benefits is not thereby penalized by taking away its ability to include an effective selection charge for the presence of cash value. You will note, of course, that doing this by way of an interest differential has the effect, which is desirable, that the two sets of values come together at maturity. Any mechanism that we would use, be it a delta in the interest rate or a table of percentages or something else has, in our belief, got to have that characteristic. So, one direction of current thinking is that we would have some linkage between nonforfeiture values and cash values, but that there would be a mechanism whereby a company could, if it wished, discount that stream of values at a higher interest rate than that used to calculate it, in order to determine what the cash would be. We seek your comments and other suggestions as well. As I said, this is one practical way we will go, but we certainly spend a lot of time bouncing it around and talking about it.

MS. BARBARA REEDY FRASER: Would you envision that this differential in the interest rate would apply to elements such as dividends that have been purchased to buy paid up petitions or excess interest that has already been credited on the universal life policy?

MR. MILLER: We have talked about that. It has the interesting effect that if you use it on a dividend to buy paid-up additions and then immediately turn it around and cash out, you have lost some of the cash, but logic would say "yes," because once you have applied it to buy insurance, you then have got a cash option that goes with it. Our thinking has been it will have that effect. Again, that is something that isn't all resolved yet. It isn't clear as to what we will do. As we have thought about it, there is no reason not to apply it to dividends or other elements.

MR. MCCARTHY: It is worth one bit of repetition that members of a committee like ours very naturally get to talking in terms of things like we will do this or we will do that. In the real world the recommendations of our committee are going to have to clear a number of hurdles, get through a number of hoops, before they might be enacted into a new model Standard Nonforfeiture Law.

MR. MILLER: Our recommendations have not even cleared hoop one, which is our own committee.

MR. MATHES: How does this affect a paid up policy, because nonforfeiture is cash value?

MR. MILLER: The same way, I would say. You have a stream of insurance costs that you are providing for. We presumably would allow them to be discounted at a higher rate. What we are talking about is building in margins for companies which having been burned over the last five to ten years, and want to have some way to deal with this issue in the future. One of the interesting things to speculate about is if such a law were passed, how many companies would actually take advantage of it? A lot of concern is expressed about this issue, there has been conversation in this and other sessions about the fact that people do not always price for all their risks. There would be nothing in such a law of the type we have hypothetically described that would require a company to price for it. Would they? I have no idea.

MR. MARK E. KINZER: It occurs to me that, if federal income tax law were changed so that policyholder cash values were taxable at any point in time, that might hasten the development of a nonforfeiture law which allowed zero cash values. Might not the opposite also occur where, if you had some types of policies which had small or zero cash values, the IRS might decide that, with the existence of those policies, all policies might not be subject to taxation and it might make it easier for the IRS to pass a law which allowed some taxation.

MR. DOLL: What you say is true. On the downside we have the pressure to have minimum tax reserves be the cash surrender values, so the IRS might consider that an acceptable tradeoff. The IRS gets less tax, but it is going to get more tax from the company from having those lower cash surrender values.

MR. MILLER: Of course, in that case I would think that the cash value floor might just be below the normal tax reserve, and it is the normal tax reserve that would govern.

MR. DOLL: Right, but at some point in time there might be pressure on the normal reserve.

MR. MILLER: There has been so far. Why not again?

MR. TOBLEMAN: I can see how the difference in interest rate could be applied to traditional policies. Exactly where are you headed in terms of universal life if you have a situation where you have fund value less a surrender charge, and ordinarily right now that is what the person expects to get in cash? How does this apply -- this difference in interest rate?

MR. MILLER: Let's for the moment hold the part about the surrender charge because that charge would presumably apply whether the policy was in paid-up status or cash status. So, in any event, imagine a net fund which is then applied forward on a basis specified in the policy to provide insurance paid-up benefits; then, discount it back at a higher rate. So, the answer to your question would be, in the particular case that you cited, the minimum cash value would be less than fund less surrender charge, because fund less surrender charge would be the value on a particular mortality and interest rate of the paid-up insurance which you would then discount back at a higher rate. By the way, there is in the audience Mr. Mateja, whom I want to cite as one of the key members, who constantly reminds us of the risks the companies take on their assets and who implores us to assure that we build in what he describes as a low floor on guaranteed cash values.