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ILLUSTRATION WARS

Moderator:	JOSEPH W. S. YAU
Panelists:	JOHN H. HARDING
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Recorder:	SELINA WANG

- o View from top producing agents
- o View from a mutual company with a history of meeting or exceeding its projected dividend scale
- o Questions that will be addressed include:
  - -- Who are the victims of the illustration wars?
  - -- What will be the effect on life insurance if the expectations of consumers are not met?
  - -- What will be the effect on the solvency of insurance companies if this continues?
  - -- Will reason prevail?
  - -- How should regulators intervene?
  - -- Should the Society of Actuaries or American Academy of Actuaries step in?

MR. JOSEPH W. S. YAU: For our benefit we would like to know who you are. Those of you who have anything to do with illustration, either as pricing actuary or in marketing roles, would you please raise your hand. We are all experts here. (About 80% responded.)

I would like to do another survey. How many of you are from stock companies? Just about half . . . and the rest I assume are from mutual companies.

All right, how many of you are from mutual companies? I guess it is evenly split.

I hope we can give you enough information that you will be worried about what is going on out there. And I also hope that after this session you would have enough knowledge to ask the right questions. Maybe we can do something about it.

What we would like to do is try to clear the muddy water. Are illustration wars price wars? What are the issues of illustration wars and who are the casualties? Are we really in a crisis? The public confidence in us is probably eroding and we need to restore it. In particular we need to define what agents and actuaries can do. We have three experts here to discuss some of the issues and perhaps offer some solutions. The recorder of the session, Selina Wang, is from Met Life. We also have Alan Press, Bernie Sloane, and John Harding.

John, a graduate from Princeton University, is well known in our profession. He has been a Fellow since 1965. He was the Chairman of the Committee on Dividend Principles and Practice. Right now, John has two very important jobs. He is the President and Chief Operating Officer of National Life and he is also the Vice-President of the American Academy. Three committees of the Academy are under his supervision: the Committee on Life Insurance, the Committee on Life Insurance Financial Reporting and the Committee on Guides to Professional Conduct. They are all relevant to our topics. John has been very concerned about the misuse of the policy illustration. He has written several articles on the topic from his perspective as a decision maker and as a leader in our profession. I am sure John can give us some insightful review of the status and the issues of the illustration wars.

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PANEL DISCUSSION

MR. JOHN H. HARDING: I will give part of this talk from my perspective, which comes from working with a mutual company that is known to have been very competitive both in illustrations and in performance over a number of years. I think that over a considerable period of time, my company has known what it should be doing, but the question is. Are we doing those things and are our competitors also doing the right thing?

I am speaking now particularly about illustrations. To understand a little bit about how we got to where we are, I think it is worthwhile to look at some of the history. Since the mid-1930s, until this decade, interest rates have done nothing but slowly go up. As a result, we had interest rates that gradually rose from around 3-7% by the late 1970s. This made the life of mutual companies relatively easy. We could overcome a lot of faults in continuously rising interest rates, but we could also do something that, for the buyer and the agent, was very beneficial. Ignoring the occasional company that chose not to pass on its improved experience, as interest rates rose, dividends normally rose and as an inevitable result, actual dividend performance, based on dividends actually paid, was significantly better than what was originally illustrated.

The general perception of the customer was that illustrations were a reliable way of understanding the competitive performance of a company. In the perception of the agents, dividends always improved, and they were reliably better than the illustrations. Perceptions of the companies were much the same: dividends always improved. Some actuaries said, once in a while, that dividends can decrease, as well as increase, but we didn't really act in ways that reinforced that fact.

If you look back at the profession and where we fall short, consider our part in two phenomena. I don't think there is a mutual company around that does not still have a little performance chart with a nice graph that shows the original illustrations and the big increase in dividends over time, over and above those illustrations. They are still being shown, still being used even though the climate is very, very different and it is far less likely that dividends paid will exceed the original illustration.

There is another measure that many companies employed to be able to make a flat statement that dividends never went down. When you made a scale adjustment that required some element to be disadvantageous to the customer, you basically waited until there was enough of interest improvement to mask it. Many companies also did some sort of pegging, and in my company, for example, we would make sure that no dividend in the new scale, all the way out to maturity, was less than the dividend illustrated previously -- not the original scale, but the most recent one. Such pegging was fine in that environment of slowly increasing interest rates, and it certainly reinforced the notion that dividends never go down. It did, however, mislead our customers and us in terms of what our business is really all about and what it has come to.

Let's consider the perception of the regulators. I would say that many regulators have looked at dividend illustrations as a reliable measure of competitive performance. When I talk about dividend illustrations, I include numerical sales illustrations for all products with some interest-sensitive or other nonguaranteed element in their pricing. The problem, though, is that there is no easy solution.

One last set of people in the upscale markets are the advisors, the CPAs in particular. And I think that the CPAs, with a few notable exceptions, still look at the bottom right-hand side or the performance side of a sales illustration and say that is a reasonable indicator of competitive performance.

If a stable environment spawned the perceptions of dividend illustrations, where are we today? It wasn't until the 1970s when you saw rates rise above 8%. By 1982, you saw that huge spike in earnings of long-term bond rates up to 16%. Then you saw a plateau in 1983, 1984 and 1985 of 12% or a little bit higher. Since 1985, you have seen a set of long-term bond yields that have fluctuated between 5% and 10%.

That high jump in the early 1980s really gave a tremendous impetus to the other things that were happening in life business; the breakthrough really in popularity of universal life and other nontraditional types of products was caused, to a great extent, because of the way interest rates would be able to be reflected in these products. However, shortly thereafter, many traditional life products also began to reflect some form of new money earnings in order to overcome the apparent disadvantage at time of sale. Those companies with high portfolio rates very often stayed with the high portfolio rate. Those with lower portfolio rates went quickly to investment-year methods.

Let's look at the relationship between illustration and ultimate performance as it has evolved in this decade. I will describe only the legitimate differences between what you can illustrate using traditional portfolio methods of interest allocation and what happens with investment-year methods.

This first concept to consider is simple and yet a little bit more complex than it sounds. While it cannot be predicted at issue, by the time a block of business matures, there is an interest rate that can reasonably describe the effective yield that was allocated to that block of policies over its lifetime. Various companies would have to do the precise calculations in different ways but, nonetheless, the concept is adequately described by a single interest rate. Let's call it the "ultimate rate."

As I said earlier, the job was very simple for a number of years. The portfolio interest rate was well below what the ultimate rate actually was. Again, it made it very easy for us all to outperform our original illustrations. It established a long-term credibility that was consistent with a slow convergence of that portfolio interest rate up to an ultimate rate over a long period of time. As we got into the decade of the 1980s, the relationship with which we were so comfortable changed considerably. Nevertheless, the portfolio rate in the early 1980s would be seen to fluctuate slowly up and could go above the ultimate rate, but come back to it in very damped oscillations.

At the time investment-year methods were first brought up and applied to various life insurance products, new money interest rates still were below what we perceived the ultimate rate would perhaps become; but they produced illustrations with a sizable advantage. But over a long period of time, probably the performance of the two products and that ultimate rate were very similar.

Now we got into that plateau period in the mid-1980s where rates for three years held around 12% or a little bit better. Now we had an environment where the new money rate was very, very high and most of us were saying that it would converge down to an ultimate rate and the portfolio rate would rise to approximately the same level. Again the new money rate would fluctuate much more widely than the portfolio rate but toward the end, the entire block of business would have a rate that fluctuated less and less because of the age of the assets.

By late 1985, both the investment and portfolio rates got above the probable level of the ultimate rate. Now for the first time almost all of the illustrations on the street were going to outperform actual results. So we had a complete inversion of not only the relationship of those illustrations of the interest rates but also of all of the illustrations that followed them. We were all using illustrations that could not be met by performance, and we were still suggesting that what we paid would be at least as good as what we illustrated.

It wasn't until 1986 that we started seeing dramatic reductions in new money rates and we started to try to cope with them.

This is the situation as we see it today. The portfolio rate at this point for most companies is materially in excess of the new money rates. Of course, we don't know what the ultimate rate will be for the business we write today. Do any of you think that the ultimate rate over a long period of time for our life insurance contracts will exceed 12%? How about less than 6%? Six percent was a lot higher than we saw a yield for many decades.

Let's narrow the gap a little bit here. How about more than 10%? Nobody is predicting that the ultimate rate is going to exceed ten. I thought we would get a few hands there. How about below 8%? Okay, that is probably about 10% of the room. Finally, how about between eight and ten? (90% of the participants raised their hands.) Even though the 8% is much higher than we had seen over the history of the business, what that really says is that almost everybody here recognizes that the illustrations that our companies are making will probably outperform the result. That's the nicest way you can say it.

So far, I have spoken without getting product specific and without dwelling on abuses. I am just trying to identify not only where I think we are but also where you, by raising your hands the way you did, recognize where we are today in what we are telling the customer.

Where we are most at fault as product actuaries is when we develop a product that fails, unless the ultimate rate is well in excess of 10%. And as a result, I think there needs to be a great deal of consideration by all of us about what happens to a product if the ultimate rate is materially lower than that rate at which we originally illustrated.

I suggest there are three types of failure. The least damaging is one where the long-term accumulations under the policy turn out to be less than what we illustrated. Somewhat more damaging are those quick-pay illustrations where we build buyer expectation that, in five to ten years, all premiums necessary will have been paid under the contract.

The last type which is, perhaps, the most insidious and the most damaging includes those illustrations where the product will fail when the policyholder is too old to do anything about it.

I suggest that these are three types of failure that we really need to think about as we design products and illustrate them to our customers. While we must try in the future to reinforce the fact that our illustrations are not predictions and are not minimum performance levels, we must also avoid designing products with built-in failure.

I think that most customers and their advisors are still blissfully unaware of what I've been talking about. They still believe that any illustration put in front of them is a prediction of the future, and they are buying in reliance on those illustrations. The regulators are much more concerned than they were a decade ago, and justifiably so. But many of these abuses are embedded and take a while to appear.

MR. YAU: We have heard from the viewpoint of the management of a mutual company and the view of a Fellow actuary. Our next speaker is Bernie Sloane. Bernie is a CLU and a Chartered Financial Consultant (ChFC). He joined Aetna Life and Casualty as an agent in 1956. He was made a General Agent in 1961. For many years he had been recruiting and training career agents, and he has also developed brokerages and supervised a number of agencies. Recently he returned to personal productions and has just qualified for the Million Dollar Roundtable. He is the first recipient of the Fred E. Hamilton Award. Bernie was the only two-term President of Westchester Life Underwriter; in 1987 and 1988 he was the President of the New York City Chapter of the American Society of CLU and ChFC. In addition to his professional activities Bernie is interested in the performing arts. Recently I invited him to a reception and he told me he could not come because he had to rehearse a show on Long Island that night. I was just curious enough to ask him the name of the show. And I think it must be amusing to a life insurance agent to produce and perform in a show called "You Can't Take it with You."

MR. BERNARD A. SLOANE: I could have listened to you forever. No you may not be able to take it with you but you might be able to enjoy it while you are here. And in discussing the current illustration problem from the point of view of a stock company producer, I think it is important to go back in time so that you understand how products for stock companies sold in the past and how the present situation evolved. Now, Joe told you I came in the business as an agent for a large stock company in March 1956. Our basic training consisted of four weeks in the home office with strong emphasis on personal insurance programming. The training also included product knowledge and competitive tools. Now I was a Career Agent with an obligation to sell my company's product unless I had a customer demand for products my company did not sell or that my company declined or highly rated as a particular risk. And I might say parenthetically that was very frequent at that time. As a matter of fact if somebody applied for $25,000 of insurance in the Aetna, they acted like they were stealing money from the company; the company required three additional afternoon blood pressure readings and two more urine specimens. And I am not exaggerating a bit. However, the emphasis on programming was one way of bypassing the competition. The agent took a fact finder, had it processed annually of course, using settlement options and recommending a solution to the prospect which would satisfy both his death benefit need and his retirement need through the cash value of the policy or policies being proposed. We were also taught to carry a Flitcraft Compend with us and we were instructed as to how to compete against the big mutuals. Now at the time, the stock company initial premiums were lower than those of the mutuals. So we tried to sell more insurance for the same premium or a lower going-in price. And we used the Flitcraft to demonstrate the fact that there was a significant difference between dividend projections and actual dividend history. Sorry John, but that is what we did. Stock company rates were fully guaranteed. The catch-up time for dividends to produce a lower premium in a typical mutual policy was seven to ten years and by using the concept of the time value of money, we could lengthen that catch-up time to as much as 15 years. Now this technique was especially effective at the older ages and I remember losing very few cases competitively. It could also be said that there was much less comparison shopping at that time. Frequently I sold business on the basis of the plan; the buyer was not even aware of the carrier until he received the policy. The key point, however, is that we sold heavily on the guarantees of all elements of the contracts; dividends, we said, were an overcharge of premiums and their projections were not reliable.

Now in the late 1960s the agents of mutual companies developed sales based on borrowing to pay premiums. First it was bank borrowing, then borrowing from the policy itself. Sophisticated minimum deposit proposals abounded, particularly when very efficient calculators such as the Hewlett Packard became widely used. Now the stock companies tried to respond with increasing term riders in place of the fifth dividend option; they were not nearly as flexible. They also introduced products like premium deposit funds as dividend equivalents. But again, they were reacting rather than playing to their own strengths. The truth of the matter is that the stock companies never developed a large book of minimum deposit business. In some ways they were great, for later on, many of the mutual companies found themselves with problems of investment and policy loans at low yields.

As the 1970s went on, the stock companies were hit very hard by inflation and rising interest rates. The mutual companies could point out dividend histories that far exceeded projections and they were able to partially overcome the inflation and high interest trends with greatly enhanced dividends and they were able to credit high rates of interest on dividend accumulations. Clearly, the stock companies were in an increasingly competitive disadvantage. To attain their market share they simply had to produce an interest-sensitive product, and universal life was their primary response. Now picture if you will the stock company agent who had a product that had total premium flexibility with high interest being credited to premium deposits and current mortality charges. Add to this the emergence of the personal computer and the results were unfortunately predictable. All kinds of interest rates were projected. Mortality charges were distorted, the agent could tailor-make an illustration that the prospect could not refuse; with his own computer, the agent could minimize or even forget to include the guaranteed portion of the illustration. I don't know any agents who did that, but I am told that somehow that might have been done.

Many of them did not really understand the difference and this is very important between this new shiny toy and the traditional product they sold for years. Training was inadequate or nonexistent. Companies simply sent out software and let the agent do his own proposal. Replacement was encouraged by relatively high commissions for internal replacement and full commissions for external replacement. And there followed an orgy of replacement business. Now that brings us to the current state of things.

In the present environment, the companies themselves have joined the illustration war with new generations of interest-sensitive products. In most cases the new products are being designed to produce more profit since the companies have discovered that their book of universal life policies was not terribly profitable and would in time produce real financial problems. So now the problem became how to introduce a more profitable product that will still look good to the buyer and to the person doing the selling. It seems to me that the preferred method is to manipulate projected mortality and interest rates in the distant future when nobody will be around to take the problem.

For example, take the first generation of a company's universal life: a $100,000 policy with practically no front-end load, an interest projection current of 8.5% and 4.5% guaranteed. Of course, you do not know what the mortality charges are except that they are current. By the way, the rate is $564 on this particular illustration at age 35. If you go down 20 years, $15,280 is the current cash value. There are ten years of back-end charges reducing until zero in the 11th year. So try to keep that figure in mind . . . $15,280, and in the 30th year (this is for a 35-year-old) you get to $31,201. And on the guaranteed side, I am not going to go through it, but take my word for it, it beats the new product at every age.

Okay, now there is the new improved product. Universal life 89 . . . hot dog! First of all they have added a front-end load up till annually 3.5% which can go guaranteed up to 6, if necessary. They have stretched out the back-end charges to 15 years and the price is approximately the same and I have used the identical interest rate. Now up to 20 years for this 35-year-old, even at the current rates, the old product beats the new; the cash value in the 20th year shows at $14,981 instead of the $15,280 . . . so they are very close in 20 years. Ah, but get to 30 years and the new product is much better . . . $34,381 against the $31,201 on the old product.

The point I am making simply is that an agent illustrating these two products is now encouraged to show the new product as better . . . better for the buyer -- even though there is an enhanced front-end load, even though the back-end load is stretched out to 15 years, and so on. But why is it better? How did they do it?

First of all at later durations after 20 years, they have a .5% interest pick up. And, secondly, they are showing much improved mortality at later durations. They look better. So now it seems to me that having done this is something of the carnival aspect to it. By the way, the longer the duration and the higher the age, the greater the difference at current rates shows when these two products are compared. And I want to stress that this is a very fine company with an excellent reputation. I can tell you about other companies' projections that are far more outrageous. It seems to me that unless some drastic steps are taken, we are going to see a very disappointed public and a proliferation of lawsuits against both agents and companies in the long run. If interest rates move down seriously and/or mortality experience deteriorates, we could also see a real increase in companies and agents in bankruptcy or pleas to policyholders for more money.

As to the remedies, from the agent's standpoint he needs to take great pains to follow the guidelines enunciated by the American Society of CLU and ChFC and make every effort to carefully explain the shared risk involved in universal life and other interest-sensitive products. I have a standard line to my prospective customer: whatever you see on this illustration I can guarantee will not come out the way it is shown. And that is the only guarantee I can make. It might be better and it could be worse but it won't be the same.

Isn't that awful that we have to say things like that in order to protect ourselves. The companies must also find ways to communicate the real nature of their products in the illustrations and in supplements to the policy itself. I think they should also require agents to submit the illustration on which the sale was made along with the application. It should be examined carefully before issuing a policy.

In conclusion I would say that as an agent, I welcome universal life. It is a good buy for many consumers provided that they fully understand the nature of the beast. But we will all be in deep trouble unless we can communicate that properly and clean up our own act.

MR. YAU: Our next panelist is Alan Press. According to Alan, he was born in a log cabin in Brooklyn. He is a graduate from Columbia College. Alan joined Guardian Life as an agent also in 1956. He was made a general agent in 1964, and his agency is always among the top five of Guardian's more than 100 agencies. Alan is the 99th president of the National Association of Life Underwriters; that makes him the immediate past president. Despite all his achievements he just told me he is most proud of being a close personal friend of A. L. Williams.

MR. ALAN PRESS: Well, it finally happened. I flew into Dallas and I took a cab to the hotel. The driver was a pleasant young man, a little scruffy looking and he did not speak English very well, and he was wearing a ratty bowling shirt with the words "DO IT" written in front in white. We got to chatting and I asked him about the message on his T-shirt. "What does it mean?" I asked, and he said, "That we do it, man." I said, "That is very nice. What do you do and to whom do you do it?" He said, "We do it man, do it, do it, do it, do it." He said, "We do it to everybody." And then he told me that he had to rush off to his other job because he said he was a leading regional vice-president for the A. L. Williams organization.

Once upon a time there was a man named Joe who was having a drink at a bar, and he got to chatting with the man next to him whose name was Pete. And Pete told Joe about a boxcar full of canned sardines that he had just bought from a man named Sam for $5,000. The boxcar of canned sardines was down on a railroad siding at the edge of town and before very long Joe bought the sardines from Pete for $6,000. Joe sold the sardines to Bob for $7,500, who in turn, before the night was out, sold the sardines to Dick for $10,000. Dick went out to the edge of town and opened the boxcar and took out a few cans of his sardines and opened one and tasted it and it was awful . . . it was inedible. Well, he threw the can away and he opened a few more cans -- the same absolutely no better. Dick went back to the bar where Bob and all of his friends were celebrating their good fortune and he said, "How could you have sold me these sardines, these sardines taste terrible, nobody could possible eat these sardines." His friends said, "Don't be silly, those sardines really aren't for eating -- they are for buying and selling."

Now the story of Joe's sardines symbolizes for me somewhat our discussion topic and that is the *life insurance illustration wars. Sometimes I have the sense that many of the illustrations that* some life insurance companies are issuing nowadays are really not for the agents, those who are going to be around for a while at least, and they are certainly not for policyholders or beneficiaries. And so I say they are maybe perhaps primarily for the benefit of people who make their money buying and selling life insurance companies.

A few years ago I noticed a series of advertisements in the industry press for a company that we will call "Courageous." *Courageous was promising universal life illustrations with an 11.5 interest* assumption when everyone else was around 10%. I checked company Courageous; in *Best's Reports* they were rated NA7 . . . how many of you know what NA7 is in *Best's*? NA7 says below minimum standard to get a letter rating. Now here was a company financially below minimum standard to get a letter rating from Best with the hottest illustration in town. Now company Courageous is essentially no longer selling universal life in this market; in fact, they are not selling any other product. But the managers of company Courageous' parent did just fine; they bailed out with $100,000,000 worth of golden parachutes and left everybody else to pick up the pieces: the agents, the general agents, but most of all the policyholders and their beneficiaries.

Once upon a time most life insurance companies issued illustrations that they more or less expected to live up to. They were managed and directed by people who were in the life insurance business. One of their goals, among others, was to make money for their companies. A perfectly appropriate and legitimate goal. Some of our life insurance companies are seemingly managed and directed by people who are in the money business. They are the gun slingers who have chosen the life insurance business as their way to make money. The product and what it does for people are seemingly irrelevant and everything else seems to be coincidental to the goal of making money.

When a life insurance company falls into their hands, illustrations that some day policyholders and beneficiaries will call upon agents and whoever is left running the company to honor policies are no more than part of the game. The difference is subtle but I think very important. Being in the life insurance business with one of your goals to make money as opposed to being in the money business and using the life insurance business to accomplish that purpose. And that subtle difference, coincidentally, provides part of the rationale for many of the things that I have done and said over the last couple of years.

Illustration wars have always been part and parcel of the process of the life insurance business. And I believe that illustration wars appropriately always will be part of the battle. As the agent consumerism matures and as comparison shopping becomes more and more part of the norm, as more and more of the gun slingers discover how many billions of other people's dollars they are to play with and manipulate in the life insurance business, the illustration wars will become even more important. Illustrations are relatively meaningless standing on their own. Is a given illustration attractive or not? Well, that depends on what else may be available in the market place, both from our industry and competing financial service distribution centers. Illustrations take on more and more meaning if and when they are compared with other illustrations from competing companies and when the consumer is sophisticated enough to ask some very basic questions. What comes with the product? Does a quality professional agent, who is committed to on-going service, come with the product or does it come with an 800 number and a recording? Sophisticated consumers will not only demand to know what a given life insurance company is promising to give him and/or his beneficiary based on whatever assumptions the company chooses to predicate its numbers on, hopefully they will also want to know what is the validity of those assumptions. What is the history of the company keeping its promises to previous generations of policyholders and what is the capacity of the company to keep its promises to future generations of policyholders?

Company Courageous did not have the capacity to keep its promises but that did not stop its managers from making them. And it seems that those managers could not have cared less and they have $100,000,000 to prove it.

The goal of war is to conquer the enemy. In the process you kill as many of the enemy as may be necessary in order to accomplish that goal. But some world leaders have begun to realize that some future wars may just not be worth winning -- depending on what you may have to do to win them and depending on what way you may be left with when the killing stops. The end of all-out nuclear chemical and biological warfare is for all practical purposes the end of civilization as we know it. And so we have begun seeing treaties limiting the development, distribution and hopefully the use of these methods of warfare. We are apparently a little more comfortable with limited killing as opposed to wholesale indiscriminate killing. Sort of like replacement.

While illustration wars will always be part of life insurance selling, hopefully responsible participants in the competitive product wars would be able to agree that just as winning all-out nuclear chemical and biological warfare will probably result in a world not worth living in, so too, the logical and ultimate result of the all-out illustration wars will probably be the end of the life insurance business as we know it.

In September 1988, a distinguished delegation from the ACLI visited the National Association of Life Underwriters (NALU) Board and asked our support in having the NAIC adopt the range method of illustrating life insurance. I assume you are all familiar with the range method. Illustrating alternative perspective results two points above and two points below current company performance. The ACLI delegation was coincidentally awesome. All buttoned up and all buttoned down, they were gorgeous. And I looked up at them and I said to myself . . . I thought, if I looked like that I could rule the world. They told us what a wonderful world we would have with the range method and the more we listened the more frightened of that wonderful world we became. Why do we need it we ask. We seem to be able to sell enough of the stuff without it and by the way we said, "We have no difficulty with two points below current performance." It is the two points above that terrified us. We couldn't seem to get an answer as to why we needed it. There was a lot of mumbo-jumbo but no sense and finally it came through . . . they said, "We want to out gun sling the gunslingers." And then we know why we did not need the range method. We don't have to out gun sling the gunslingers to make a living selling life insurance. That is precisely the kind of illustration warfare that will destroy the life insurance business for everyone but the gunslingers.

Not only did NALU say no to the range method, we went to the ACLI Board and we prevailed on them to withdraw their support from it. And this, by the way, was a perfectly fascinating reversal of expected roles in that here were the companies seeking field support in an effort to illustrate the product more aggressively and the field insisting on conservatism and prevailing.

Well, now it is time for me to attempt to answer Joe's questions. Question number one: Who are the victims of the illustration wars? Everyone but the gunslingers -- that is, agents, general agents, home office employees who go along. Company Courageous' actuaries' resumes are still on the street. To a certain extent we are all economic slaves and we have it too good. But most of all the ultimate casualties of the illustration wars of illustration abuse must be the policyholders and their beneficiaries.

Question number two: What would be the effect on the life insurance business if expectations of consumers are not met? One of my favorite actuaries, in fact one of my favorite all-time heroes, is a man by the name of Irving Rosenthal. How many of you remember Irving? Irv was the executive vice-president of the Guardian for many years and he once said to me, "Forty years is but a day in the life of a life insurance company."

Some of you remember Irv back in the mid-1940s. He wrote a landmark paper for the old American Institute called "Limits of Retention for Ordinary Life Insurance." That should tell you something about me by the way; I am a guy who has spent 33 years selling life insurance and I claim an actuary as one of my heroes. Ours is obviously a long-term business. We are making promises and no matter what else, whatever kind of disclaimers we may put on those illustrations, no matter how many lines of footnotes or pages of footnotes, our policyholders look at them and say, that is what they are promising me. And memories get a little hazy a month after you have left the kitchen table, let alone five or ten years after you have been to that kitchen table. But ours is a long-term business and we are making promises, some of which we will not be called on to keep for 30 or 40 or 50 years or even longer. More than almost any other, the life insurance business is dependent on consumer confidence for its long-term survival and viability.

Ultimately everyone keeps score. So if we fail to conduct our business responsibly, those of us who are in it for the long haul will get exactly what we deserve. That, by the way, is again the reason I have spoken out on so many issues the way I have.

Question number 3: What will the effect of insurance companies be on solvency if this continues? And I underline that, Joe . . . if this continues. You know better than I what the effect on companies' solvency will be. But I and many like me who care deeply about this business have great fears for what it will all mean if this continues.

The next logical question that Joe asked is, will reason prevail? Life insurance salesmen are eternal optimists and I must believe that reason will prevail; otherwise I could not go on.

Should the regulators intervene? I believe that the job of regulators is to protect the consumer.

Of the regulators I have met, most of them are very sincere, hard-working decent public servants, and I am also realistic and therefore not very sanguine. Most insurance departments are underfunded and overworked, and most of the people who go into insurance departments are generally not risk takers. Additionally, regulators are primarily like most of us, firemen. Most of us spend our days putting out fires, today's fires. Regulators need to concern themselves with issues like companies that are about to be insolvent or are insolvent today, not companies that may be insolvent in 10 or 15 years. They must be concerned with the availability of auto liability insurance and the cost of that insurance, professional liability for the medical profession; they're concerned with people who steal premium and claim checks as opposed to people who steal policyholder reserves. Remember, you are more likely to go to jail in America for stealing a loaf of bread than for stealing a company.

Finally, regulators are generally concerned with getting reelected or reappointed. That certainly is legitimate and appropriate. I do not believe in tenure and everyone should have a boss.

Question number six. Should SOA or AAA step in? I always thought of the actuaries as the conscience of the life insurance industry. Our conscience with the notable exception of a few, very few, has been notably silent. You are probably the only ones who can get this thing under control. The solutions are really simple. All it will take is a few good people with the courage to stand up and cry, "Shame." Remember Edmond Burke? He said, "Evil triumphs when good men remain silent." Will you remain silent? Will you allow evil to triumph?

MR. YAU: I would like to ask a question to the panel, especially to John. As we know, the illustration war was more like a marketing practice than really a war. What have we done to restore the public confidence in us, especially the Academy or Society?

MR. HARDING: What have we done to restore public confidence? I'd say precious little. Let me tell you the history of what our profession has attempted to do and the degree to which I think we've either succeeded or failed. In the late 1970s, the SOA put together a committee, one of several in succession, to deal with the question of dividend, principles and practices. They set forth a standard that is very similar to the pattern of many standards that have been put together in the actuarial profession since in that it identifies a range of things which you can do, and in essence says beyond that you must disclose it. Now, at that point, the job was turned over to the Academy to try to put the entire matter in place, and I was chairman of that particular committee, and in fact, on Halloween 1980 we did get a standard adopted, which I think in most respects is still in place. Subsequent to that, there was a standard I believe in 1986 on other nonguaranteed elements that was put in place.

What both of those committees recognized, however, is simply telling the actuary these are the standards that you should follow was not going to do it. First of all, as I said, the idea of disclosing anything that you had not done in accordance with the standards, the question is disclose to whom, and in fact, the actuarial standards say you disclose it to management. Well, management may or may not have the right interest involved in coming to the result that we all have talked about wanting.

So in addition to that, we requested that the NAIC put in the statement blank, in Schedule M to begin with, answers to some interrogatories about that disclosure, and some of those interrogatories included the question about whether or not the actuary had in fact followed these standards. Another question was, are the illustrations based upon current experience? If current experience continues, could the scale be continued? Finally, there was a question about do you anticipate in the short-term future a deterioration in short-time experience that would lead to a change in scale?

Those questions were informative; unfortunately, they had to go through the committee where the interest in market conduct is not top priority, let's say. As a result, the disclosures are generally in a supplement and are pretty hard to get hold of. You can get hold of them and you can read them, but certainly they did not become anywhere near as effective a tool as we had anticipated. We also had put together some suggestions on how you link that disclosure to what ought to be put on the bottom of an illustration. Those never got anywhere.

Now, I think that this may be a part of our problem; in fact it is a distinct part of the problem. The actuaries were just one player in the game and that market conduct is certainly something in which we have a responsibility but not a primary one. So we are playing from a relatively weak hand when we attempt to, as your question said, step in.

MR. WALTER N. MILLER: There's one very important piece of this story that we should get on the record right now, though. Bernie Sloane referred to recently adopted professional practice guidelines by the American Society of CLU. These were adopted by their Ethical Practices Committee, I believe, about a year-and-a-half ago. They consist of a checklist which the agent -- it is not mandatory at this point -- may use in providing additional disclosure to his or her clients in connection with a particular sales illustration. A large portion of the items on that checklist are drawn directly from the annual statement interrogatories that John just mentioned and which originated with action by and suggestions by committees in the Society and the Academy, most of which was later picked up by the NAIC. Obviously, this is not a magic bullet solution.

I had the pleasure of working with the Ethical Practices Committee in putting that checklist together that way. They had a lot of hope for it. They knew that a strong educational effort was going to be necessary, and I think this is ongoing in getting CLUs and ChFCs to use these guidelines. Of course, that doesn't cover the entire agency force in our country, but with due respect to some very powerful oratory and the situation that every one of us knows has a long way to go before it can be corrected. I would submit that the only group that has done anything meaningful to try to attack the questions of illustration wars through the process that John described and through the way in which the American Society of CLU has picked up on it is the actuaries.

MR. HARDING: I'd like to pick up where I had left off. I think that's a very important point and I'm delighted to hear it by the way, about the CLU attempts at dealing with this same issue because I think it is going to have to come from a number of responsible parties.

One of the jobs that has been assigned now to the Committee on Life Insurance in the Academy is a study of, in fact, where we have succeeded and where we have not and what needs to be done in order to further assist the process of bringing some sanity back into the illustration situation. I would point out, however, that even the legitimate practices produce very different answers on an illustration that shows an apparent competitive result at point of sale. And I further believe that it is unlikely that you're ever going to be able to mandate a set of limitations that will in fact unscramble that particular egg. Nonetheless, I think we do have to go on and that this should be a process where all interested parties, including the agents, including the ACLI, including the NAIC, start to work together to try to bring some semblance of order to this process.

MR. YAU: I'd like to ask the other panelists, what is the most important thing that we can do to restore public confidence in our business, especially from your agents' point of view? One thing, not many.

MR. SLOANE: When you say we, who's we?

MR YAU: You.

MR. SLOANE: What I think has to happen is that one way or another, probably through communications, appropriate communications from agents' groups, possibly actuaries or companies, the public really has to get a better handle, a better education of what these products really are. The key problem as I see it, and one of the things that has fed the illustration wars to such an extent is the fact that the public is still thinking in traditional policy terms without understanding the nature of these new interest-sensitive products, and until they can get sort of a handle on that, they're just fair game for, as Alan has put it, the gun slingers. I don't know exactly how to do that, but I know it has to happen. Some agents are doing it on their own. I haven't seen any real response from the companies that really try to explain the differences between the traditional products and the new ones, but I think that they have an obligation to the buying public to become part of the solution instead of the problem.

MR. PRESS: I think that we have begun to touch on a problem that is probably bigger than the issue of how does the agent and/or the actuary approach this, and I think I somewhat alluded to it in my early remarks, but it is this matter of public confidence in the industry, which obviously all ACLI studies show is significantly eroding. The tragedy of the erosion of public confidence in the industry is in reality, aside from all of our, as Bernie called it, warts that we all bring to the table. If you look at the financial services industry, we're the good guys. We have done it well. By and large, we have kept most of the promises we have made over the generations to the policyholders.

Now certainly the problems with illustrations are contributing to the problem of the erosion of public confidence, but the illustrations are really not the cause of the loss of public confidence in the insurance industry. That loss goes to much, much greater, bigger and wider influences that we're going to have to respond to if we're going to remain viable as an industry. There's the craziness of Proposition 103. I mean, look at what those people voted for and you know how insane that piece of legislation was, but indeed, it was a response to the idea that the insurance companies are the bad guys and have been ripping off the public and here's our chance to get them under control. We really haven't made the public understand that in fact we are not the bad guys, that we are the good guys.

Of course, all of you are aware that I have been part of an effort, as I see it, to tell the truth, what I see as the truth about our industry and what we have done versus the perception of A. L. Williams of our industry. Now if you talk about public confidence, keep in mind that every day he's got 200,000 agents out on the street saying that industry is ripping you off and has been ripping you off for 100 years and everything they're selling you is junk and they're not going to keep their promises and they have never kept their promises, and this is just a way of getting your money to use it for their own purposes.

Now, if there are 200,000 people out there of which he's recruiting 150,000 a year and those 150,000 people a year are going out, think of the ripples and the waves. What does that mean when all of those people are going out there telling other people -- believing that our products are indeed ripping them off and have been ripping them off, completely distorting the performance of those problems of those products, and yet the industry remains silent. We do not respond. We are the world's best salespeople and the world's worst communicators. We just don't really know how to communicate what it is that we do and what we have done and we say to hell with it, let's put the money somewhere else. Maybe we've got to learn how to communicate but we're certainly not doing a good job of it.

MR. SELIG EHRLICH: Without belittling the scope of the effort it's going to take within the insurance industry to address this question, I'd like to broaden the problem to say that it extends beyond our industry and do that by telling a short story of my first exposure to this problem. It was back in 1982 when I went off to see our lawyers about the single premium deferred annuity (SPDA) illustration and its footnotes, and one of them pulled out a *Times* and said, "Forget about the footnotes; this is what really galls me." -- it was around March time frame. She pulled out the paper and there were the IRA ads, full-page ads by all the New York banks saying you give us $2,000 a year, you will be a millionaire when you retire. So we've got a lot to do internally, but at the same time we are facing this competition from others in the financial services industry who may be doing less and how one continues to be the good guy and still meet the conditions of the marketplace just makes the problem all the more difficult. And if anyone on the panel has a way to respond to that, I'd be interested in hearing it.

PANEL DISCUSSION

MR. HARDING: I can't disagree with you. I think if you try to attack the problem through regulation of our industry, that by itself leaves us very vulnerable to a competing financial services industry that in fact would not be regulated in the same way.

MR. SLOANE: The analogy is good, but it is inadequate in my opinion. The people who were putting the money away were putting it away because they had a tax savings and they didn't have to believe that million dollars. It wasn't crucial that they believe that million dollars. The buyers of insurance policies have traditionally believed, and with good cause, that the policy would do what it said it would do. It was backed by guarantees, it went through the depression, it went through all kinds of recessions and the industry always performed. It's a very different story when you put your children and your family on the line, as it were, over a long period of time than when you're making a tax-favored investment. So while I agree that others have exaggerated or maybe done as badly, the fact is that ours has always been a complex illustration; we have tried to communicate all kinds of ideas that the public never really fully understood but they still believed that we would deliver on our basic promises. The point that I've been trying to make is that they still believe it, except that these new products are so different and they don't understand the difference and half the people selling them don't understand the difference, and that creates a very serious situation. That's unique to us.

MR. NATHAN F. JONES: I was present when the decision was made on a point which is now of great interest in view particularly of what Mr. Sloane said. I was present when the decision was made not by me nor by my boss who is in the room at the present time -- and Alan said everybody should have a boss -- that the universal life illustrations in New York, if they wanted to show any numbers at all, had to show the corresponding guaranteed numbers, and that's in the illustrations now and, therefore, I was not really appalled but a little disappointed that Mr. Sloane said you couldn't believe anything on the illustration because if it's a New York illustration, and in general the ones I've seen have complied with this, they show the guaranteed numbers, and those really are guarantees. The only trouble is that the policyholders or prospects, and presumably the agents, think that they are of no importance because obviously those guaranteed interest rates, which is what everybody looks at, are 4% or 4.5% and nobody would ever buy a product like that if that were the rate he anticipated. Therefore, they immediately discount it down to 0 and look only at rates that are not guaranteed. On the other hand, that decision, which as I say, was not made by me or by Bernie, that did do one thing for us -- and I'd like to get the department at least that much credit.

An ad for an IRA appeared in the *New York Times* which said up at the top, 15% -- that was in 1983 -- in large type, and they went on from there. The New York regulation or circular letter, really a regulation, at least stopped that because I haven't seen any of those since then, because if you said 15% and if you set it in large type, you'd have to put 4.5% up right next to it in equal-size type to comply with that regulation.

MR. MILLER: Nate, you were the notable exception, and you're absolutely right.

MR. SLOANE: All the illustrations in some way do demonstrate the guaranteed value -- some of them on the second page, some on the right, some on the left. And, as you say, they are discounted, not only by the agent who says, "You're not going in at 4.5, you're going in at 8.5." So this really doesn't mean anything because it assumed you're going in at 4.5. The point at issue is you're absolutely right. If anyone wants to take the guaranteed values and stress them, there is some protection there, just not enough.

MR. THOMAS L. BAKOS: It seems to me that the illustrations are a problem not just because of the forms the illustration takes, but because of the form the products being illustrated take, and I think that's been hinted at here, and it was nice to hear Walter Miller say that actuaries are part of the solution, but it seems to me that some actuaries somewhere had to be involved in the design and development of these products that are being illustrated.

What is the panel's opinion as to who, if any one person is responsible for the situation we have?

MR. HARDING: I already indicated when I spoke earlier that I felt that our profession had created a part of the problem with product design. I don't think we're holders of the whole bag, but we certainly are part of it.

MR. PRESS: Tom, I don't think you can have a who. I think the who goes back to maybe 1979-82, when the insurance industry nearly disappeared because of disintermediation. We couldn't continue with what was going on at that point. And then, of course, there is the huge competition for control of assets. Everybody thinks that control of a large block of assets is the key to the future. So the emphasis seems to be on asset growth, not on profit growth. Somehow or other get your hands on huge blocks of money; do whatever you have to do to get your hands on huge blocks of money and future rate increases will take care of future interest rate increases, as Bernie said and as John said, they would take care of any sins that you may commit in the process of getting your hands on those blocks of assets. Obviously it didn't work out that way. So the issue is not, from my perspective, Tom, how did we get into the box? The issue is how do we get out of the box now that we're in it? Who should be in charge of designing the product, the product design? I must tell you that I don't know because I have never been involved in the process and I don't understand the dynamics of product design. After 33 years, I know something about selling it, but what you guys do is an absolute mystery to me and someday I would love to take six months and learn how people actually price the product and what are the inputs and the dynamics. I certainly wouldn't presume to comment on how life insurance products are designed. I don't understand the process.

MR. LAWRENCE P. MOEWS: I had the honor of hearing Jane Bryant Quinn speak recently. She's a financial columnist. She was asked what are the most pressing issues in the insurance industry from her perspective, from the press perspective. She could have picked Proposition 103; she could have picked health care. She could have picked lots of things, the Bank Investment Contracts (BICs) versus the GICs and all that stuff. But she picked the phantom illustrations in the life insurance industry. So it gives you an indication of how serious she thinks this problem is.

The question I have for the panelists, beyond what's already been discussed -- Is anybody doing anything beyond the ACLI's attempt that was mentioned before? Is the NALU doing anything at this time? Has the Academy got anything going on currently or the CLU as we mentioned before? Does the panel have any updates on any of those?

MR. PRESS: Are they doing anything to what?

MR. MOEWS: With respect to proposals of conduct in the future and maybe even legislative changes with respect to the NAIC and so forth.

MR. PRESS: Nothing of significance is happening at NALU.

MR. HARDING: As I mentioned earlier, the Committee on Life Insurance of the Academy is putting together a study that can be used as a starting point to raise some of the issues through the auspices of the Academy and also I hope through the ACLI.

MR. SLOANE: As I mentioned, the American Society of CLU and ChFC has put out a set of guidelines which are voluntary but which they are asking agents to follow in properly informing prospects about the products. Also, I believe everybody is suggesting that you have your Error and Omission (E&O) premiums paid.

MS. DAPHNE D. BARTLETT: With all due respect to Walter Miller, I believe that disclosure in the annual statement isn't doing one darn thing to help the consumer. The consumer isn't going to know unless told by an agent of another company that dividend illustrations or universal life illustrations are unlikely to be met. I think that there's a lot more that the actuarial profession should be doing, and I urge John's Committee on Life Insurance of the Academy to pick it up, proceed with it, and do something at the illustration level. It's not an actuarial issue specifically, but I think that if we don't do something, somebody else will and it could be a lot worse.

MR. YAU: In closing, I would like to offer a few observations. First, I want to make a disclaimer. I'm speaking for myself, and my comments do not reflect the view of the Met Life or the Society or the Academy. The comments are all my own.

First, it's obvious there is serious misuse of policy illustration. On the other hand, it's almost impossible in my view to set up a standard for intelligent comparison of price that's the primary use of illustration. We know what realistic assumptions are, but can we argue that a 50 basis point difference in the interest rate or 10% difference in mortality assumptions or a 10% difference in expenses. Over many years these small differences could have an enormous impact on the product performance.

Second, I think too much emphasis is put on the illustration in a sales situation. There are other equally important factors such as the reputation of the company and the agent, the history of the actual versus illustrative values, services provided or the financial strength of the company, and the record of fairness in dealing with all policyholders. These I think have been neglected. Alan has said that actuaries are the conscience of the insurance industry. Do we deserve such honor? The Guides to Professional Conduct of the AAA says, "The member will act in a manner to uphold the dignity of the actuarial profession and to fulfill this responsibility to the public."

What is our responsibility to the public? Certainly, the attitude of "let the buyer beware" is not. Perhaps we can work harder to make a more complete and meaningful disclosure. I think not only the current assumptions but maybe the experience and the condition on which the current assumptions are based should be disclosed. If the experience and condition are not likely to happen or to continue in the future, we must adjust the assumptions accordingly, and all of these considerations should be disclosed to an agent and the public if necessary. In this way, I believe we are honestly trying to project a proper outcome and not an overly optimistic future and possibly misleading projection.

I think it takes courage to do so. Maybe our profession can help us. We can work closely with regulators to draft regulations to fulfill our responsibility to the public.

There's another section in the Guides to Professional Conduct that I'd like to quote, "The member will have due regard to the requirements of laws and regulations, recognizing their intent with respect to the designated publics."