RECORD OF SOCIETY OF ACTUARIES
1990 VOL. 16 NO. 3

QUALITY OF LIFE INSURANCE SALES ILLUSTRATIONS

Moderator: ANTHONY T. SPANO
Panelists: NORMAN K. MARTIN
PHILIP K. POLKINGHORN
Recorder: ANTHONY T. SPANO

- This session will focus on regulatory and other approaches for enhancing the quality and credibility of sales illustrations for life insurance products involving nonguaranteed elements. Included will be a discussion of:
  - Advantages and disadvantages of different approaches
  - NAIC policy information forms
  - Review of annual statement interrogatories and illustration practices with regard to nonguaranteed elements

MR. ANTHONY T. SPANO: Let me welcome you to this session on the quality of life insurance sales illustrations. I'm Tony Spano with the ACLI in Washington, D.C. My panelists are Norm Martin with State Farm Life, Bloomington, Illinois, and Phil Polkinghorn with Tillinghast/Towers Perrin in Hartford, Connecticut.

Those of you who have been attending Society meetings for a while will recall that a common subject on meeting programs in the late 1970s and early 1980s was life insurance cost disclosure. The discussions in those days involved such questions as: How much information should be disclosed to the consumer at the time a policy is being sold? What information should it be? What index numbers should be given to the prospective purchaser to enable comparison of one life insurance policy with another? At what point in the sales process should this information be given?

The product scene in those days was much different and much simpler than it is today. I joined the ACLI in 1979, and those were just about the last days of the old marketplace. We basically had term insurance and whole life insurance, and participating insurance and nonparticipating insurance. Everything was guaranteed except for policy dividends on participating insurance. And with respect to policy dividends, the situation was quite straightforward. Each company had a dividend scale that would be approved annually by the board of directors, and any sales presentation to an applicant, if it included dividends, would show dividends on the company's then current scale.

We all know it's very different today. It isn't just dividends that are not guaranteed. For that reason, the whole subject of cost disclosure has evolved, and the focus today is entirely different. We no longer discuss what cost index is best, but rather how we can make sure that the information given to the policyholder is not misleading -- that the policyholder knows, for example, what is guaranteed and what is not guaranteed.

We're going to start with Norm, who will give a broad overview of this whole subject since it first came onto the scene in the late 1960s. Norm will review the past. I'll then

discuss a recent regulatory activity aimed at improving the credibility of the sales information given to applicants today. So I'll be talking about something occurring now. Then Phil Polkinghorn will look toward the future. Phil is involved in a group that is considering several interesting, and in some cases novel, approaches for enhancing the meaningfulness and credibility of consumer information.

MR. NORMAN K. MARTIN: It's been nine years since I've been on the program on this particular subject. It hasn't died in the nine years, and the chances are it won't die in the next nine. I may not be here. But it's not going to go away; things keep changing.

As Tony already said, my job is to attempt to describe some of the history of cost comparisons. I think it's important to know where we've been and what has been considered in the past. In that way, we can have some appreciation of the more recent proposals, at least one of which will be discussed later by Tony.

I do need to point out that I will be talking primarily about events and proposals at the national level. Individual states have, on occasion, gone off on their own in attempting to address perceived problems. Sometimes the approach they have taken has appeared rather cavalier. The attitude has been: we'll require something, and if it doesn't work we'll discontinue it. The industry has attempted to discourage these individual efforts, trying to retain some uniformity across a broad geographic and operational base. Perhaps as we become more flexible with advances in computer technology, a variety of approaches would be more acceptable.

I also intend to discuss requirements that would apply only at issue. There was an attempt at one time to require companies to show not only the "cost" at issue but also to show on annual notices both the current dividend and what the dividend would have been under the original scale. The reasoning was that this would discourage companies from exhibiting overly optimistic scales or from not living up to their illustrations. While that might be the case, there is the possible adverse effect of encouraging a company to continue a scale in existence past the time when it should have been discontinued.

We also need to recognize, as Tony has already mentioned, that the target is forever moving and that some of the ingredients have changed. At the time consideration was first given to regulations concerning cost comparisons, there were no interest-sensitive contracts as we know them today. While these might have been feasible, they weren't too practical in terms of technology. Also, I don't believe companies were using new money rates in dividends; virtually everyone was on portfolio rates. Again, technology has made these applications more practical. Indeed, during a period of high and volatile interest rates, innovative approaches such as interest-sensitive contracts and new money rates were almost demanded if the life insurance industry was to remain viable.

For many years, life insurance was sold by a simple illustration which showed the total premiums paid over a period of time; the values, including dividends, at the end of that period; and the gain or loss, referred to as cost, which was the difference between the two figures. Then in 1968 the late Senator Hart from Michigan, in an address to the American Life Convention, advised the industry that they should improve cost disclosure. Senator Hart had become somewhat frustrated when the Veterans Administration told

him that they could not advise veterans as to which policies might be attractively priced for conversion of GI insurance. This challenge to the industry, in my view, was the beginning of required life insurance cost disclosure.

The industry accepted the challenge. A joint special committee of the major life insurance trade associations presented a report in 1970 that started us down the path to cost disclosure. The committee found that the traditional net cost comparison, a simple comparison of premiums and values, was flawed. One of the problems was that the cost, as shown by most companies, was negative. The committee recommended that, for comparative purposes, the 20th year interest-adjusted surrender cost index was preferable. This required one figure, which was to represent the cost of the policy. It was an adaptation of what had existed before, a comparison of premiums and values over a period of time, with the exceptions that the period of time was now fixed at 20 years and that the premiums and values were adjusted for the time value of money at a particular interest rate. The interest rate to be used at that time was 4%.

The NAIC, working with the special committee's report, brought out a model solicitation act in 1973. This model act required that interest-adjusted surrender costs be furnished at the 10th and 20th durations. Note that we were now up to two figures to be used for cost comparisons. Two durations were picked in case a prospective buyer did not plan on keeping the policy for as long as 20 years.

Because of the debate which occurred as the model solicitation law was presented in the various states, the NAIC requested the SOA to review several methods of attempting to measure the cost of a policy. The Society responded and in 1974 received a report which was prepared by a special committee. The request or challenge seemed to be quite satisfactorily met. A great variety of approaches for determining cost were compared in an algebraic or statistical sense, and a database of actual figures was used to determine the effect, if any, on the relative competitive ranking among companies when different methods and parameters were used. As you would expect, different methods did alter the rankings among companies. My interpretation was that, although the relative position of the various companies' figures did change, they did not change significantly. It is also interesting that the report disclosed that minor modifications in the interest rate used in the calculations did not significantly alter the rankings among companies, at least as far as the interest-adjusted index was concerned. Said another way, regardless of method or interest rate, a good policy is a good policy and a bad policy is a bad policy.

In 1976, the NAIC revised the model law to incorporate four more figures, the 10th and 20th year net payment indices and equivalent level dividends. This now got us to six figures. A *Buyer's Guide* and a ledger statement were added requirements. Also, the interest rate to be used in calculating the indices was increased from the original 4-5%.

The requirement of a ledger statement indicates that it was at about this time that the regulators began to show an interest in more disclosure than just costs. There was a feeling that the insuring public should have an interest in how the values of a policy progressed, what the true cost of insurance was, and how much money the companies were making. Companies now had to show the six indices and furnish ledger statements showing a variety of values.

It was also in 1976 that the federal government began to show an interest in life insurance, as the Federal Trade Commission (FTC) announced its forthcoming investigation into the industry and the costs of its products to consumers. In its announcement, the FTC anticipated they would find a lack of competition in the marketplace, and they also anticipated that perhaps a rate of return might be a better competitive and comparative tool than anything yet devised by the industry or the NAIC.

The Senate Subcommittee on Oversight and Investigation held a hearing on life insurance in 1978. The Subcommittee's subsequent report suggested that a Linton Yield, a company retention index, and a yardstick for comparative purposes would be helpful. In 1979, the FTC report was released. This report created quite a few waves and a good many headlines. Also, as anticipated, the NAIC method was deemed not adequate -- a rate of return should be required -- and, surprisingly, there was no competition in the marketplace. As the 1976 NAIC model was considered in the various states, there was an FTC presence at the hearings. Needless to say, the interest shown at the federal level served as a catalyst for additional activity at the NAIC, or state, level.

Early in 1980, the NAIC considered an approach to disclosure which involved figures for each of the first 30 policy years and was nine columns wide. The columns included measurements labeled as probable cost index, probable annual cost, yearly rate of return, and a company retention type of figure. This would have truly been disclosure, but a far cry from the initial desire to have a simple index to indicate whether a policy was a good buy. This approach was never adopted.

The NAIC revisited the area of cost disclosure in 1983. The model was updated to bring in special plans such as indeterminate premium and universal life, and also the non-guaranteed elements to which Tony has already referred. The *Buyer's Guide* was changed at this time to incorporate references to these new policies and their terminology. The regulators were also concerned about unusual patterns of premiums and benefits, and they exhibited this concern by requiring the calculation of a "discontinuity index." This index required calculation of the backward second differences on the yearly price, which was defined in the proposed model. This discontinuity index was to be disclosed to the regulators in all instances, and to the public on request, or if the results were outside a given set of parameters. If the discontinuity indices were outside the given parameters, a company was required to disclose why and what ingredient was causing the variations. Dividend practices -- the use of investment generation versus portfolio method -- were to be disclosed to both new and existing policyholders.

Notice the growth in the proposed number of figures: one cost index to two, to six, to ledger statements, and then to proposed discontinuity indices. These requirements might be desirable, but they're not necessarily compatible. The original thinking was that, the simpler the basis of comparison, the more readily it would be understood and the more frequently it would be used. Full disclosure, on the other hand, would require a multiplicity of figures, which would seem to be at odds with simplicity and, to a good many people, would be overly confusing.

In 1985, the FTC again visited the arena of life insurance costs. The general feeling was that this later report was much more balanced then the first. Certainly, it did not have

the publicity which attended the first report. The types of policies considered in the report were annual renewable term, participating and nonparticipating whole life, and universal life. The conclusions in the report were based mainly on the use of Linton Yield or rate-of-return to compare different policies with each other and with other financial instruments.

One of the conclusions of the report was that life insurance consumers do not have adequate information with which to make informed purchase decisions. In this regard, one of the authors of the report cited initial, negative short-term yields and high lapse rates in the early years, as well as a considerable variation among the results of different companies. It was conjectured that the difficulty consumers might have in evaluating the benefits of different policies might be causing inferior policies to drive off superior policies in the marketplace. Countering this, the report also had a section which focused on the potential differences between permanent life policies and alternative financial strategies. This included features unique to life insurance which involved significant costs to companies and could be of significant value to consumers. It was believed in this section of the study that it was not possible to make meaningful comparisons of permanent policies with other financial instruments. Indeed, it was a very moderate report when compared with the earlier one.

In contrast to the FTC's expressed preference for a rate-of-return, a well-known financial writer in the public press quite recently seemed to endorse use of the interest-adjusted indices. A hurried reading might lead one to conclude that she advised against using the interest-adjusted indices when shopping. But a closer reading disclosed that she was not necessarily against that index system but that, in her opinion, indices from a single company would not indicate what was a good buy. Her point was that such numbers needed to be obtained on the policies from several different companies. In addition, she charged that the numbers could be manipulated so that at the durations illustrated, a company could be accused of inserting "garbage" into the calculations. This may, of course, well be true for any system which is designed to be used in policy comparisons. Her solution was to let a third party compare the interest-adjusted indices and make a recommendation.

At the current time, about three fourths of the states have adopted the NAIC model in one form or another. The 1976 version has been adopted in 34 states, and the 1973 version has been adopted in four states, with three of those four states changing from the original 4-5% interest rate for calculating indices. No states have adopted the 1983 version in total, but two states have adopted the most recent version of the *Buyer's Guide*. There is continued support for the NAIC model from two important industry groups, the National Association of Life Underwriters (NALU) and the ACLI. While the NALU might originally have been reluctant to support the NAIC model, it did realize the importance of uniformity among the various jurisdictions as a variety of alternatives were proposed.

That brings us to the most recent era, that of the interest-sensitive contracts. In recognition of the interest-sensitive contracts, the regulators sought a way that policies could be compared on the basis on which they were being sold, namely, interest rates. A

special NAIC Yield Index Advisory Committee was appointed and charged with developing a yield index for interest-sensitive life insurance policies.

In 1986, this committee presented a report containing proposed amendments to the Life Insurance Disclosure Model Regulation. The committee took no position on whether disclosure of yield indices should be required but stated that, if required, the indices should be in the form recommended by the committee, which involved a modified Linton Yield. The committee also indicated that any index should not be limited to interest-sensitive products but should apply to all policies with significant cash values, where significant was defined as $200 per $1000 of death benefit at any time during the first 20 policy years. Yield indices would be required on both a guaranteed and an illustrated basis and at the 5th, 10th, and 20th durations. Any illustration should disclose if it displayed costs or benefits more favorable then those based on the nonguaranteed elements of similar in-force policies. Linton Yields require the use of assumed term insurance rates; the rates recommended by the committee were representative of the low rates available in the market, but not the lowest.

Responses to the committee report included a feeling that it would be a mistake to proceed with yield indices until the problem of credibility of illustrations was solved. I think the NAIC, in establishing the committee, was attempting to respond to what were termed at the time as the "big red 12 percents" that were appearing in the newspaper advertisements. Some of these numbers were still being illustrated at a time when market rates would not seem to support them. A possible alternative that was suggested was to permit illustrations on some prescribed interest rates, say 0, 6, and 12%, as is done with variable life insurance and mutual funds, rather than relying on companies to use their own experience rates or fantasized rates. Considering the number of indices that were being suggested, another possibility was to require these prescribed rates only if requested by the purchaser. Another concern expressed if rates of return were to be required was the possibility that life insurance would be considered an investment and compared directly with other investments without recognition of the unique features of insurance products. The NAIC adopted the Committee's proposal as an optional form of the Life Insurance Disclosure Model Regulation for those states that wish to require a yield index.

In 1987, the NAIC amended the model advertising rules to require that illustrations of nonguaranteed elements be based on the company's current scale. There are currently three states which have such a restriction on illustrations. In recognition of what was happening in the marketplace, and in response to this current scale limitation, consideration was given within industry circles to a "range approach." This approach would permit a company to illustrate interest rates on either side of the current rate being credited. For instance, if a company were actually crediting 8%, it could illustrate the results of using a 10% rate but, if it did, it would also have to illustrate on the basis of 6%. The range would be, say, 2% on either side of the actual rate being credited. One variation included the possibility of a cap on the rates which would be permitted. Questions arose as to whether the cap should be expressed as a maximum rate or as a given percentage above the current rate. Another alternative was to link the range to an index such as Moody's.

If it had been pursued, the range approach might have addressed the concern that regulators had in the interest factors that were being used in illustrations for interest-sensitive policies. Among the problems foreseen with the range approach was that it did not lend itself readily to traditional dividend-paying policies. Also, a problem would have existed in illustrating ranges for mortality and expense elements in these policies. The range approach found no support within the NALU and only temporary support within the industry.

That brings us up to date, with the exception of the most recent NAIC development, which involves consumer disclosure forms for universal life and indeterminate premium policies. Tony is prepared to discuss these.

MR. SPANO: Norm has covered a good bit of history, describing activity over a number of years. Very modestly, he did not mention that during this time he was very much at the cutting edge of developments.

I'm going to discuss what Norm referred to as consumer disclosure forms. They're also known as policy information forms. I'll first cover some background, then describe the forms and the major issues that arose during their development, and finish with a few words about the next step in the process.

BACKGROUND

The policy information forms were developed by the NAIC over a period of a year and a half. The impetus for the effort came from some of the state regulators, particularly William Hager, then insurance commissioner of Iowa. Some of you may remember Mr. Hager from a few years back when he was general counsel of the AAA.

The first word about this project came at the June 1988 NAIC meeting, when a report was presented summarizing the results of a survey of the different state insurance departments on consumer disclosure concerns. The report cited a number of alleged abuses regarding sales illustrations for interest-sensitive products, including the following:

- Illustrations with "outrageous" interest rate assumptions.
- Current rate illustrations based on a different rate than the one currently being paid.
- Nonguaranteed elements built into the calculations. (I assume this meant that nonguaranteed items were being blended with guaranteed items in some of the calculations.)
- Unrealistic assumptions, such as increasing interest and decreasing mortality.
- Illustrations which include items not in the contract.

A regulatory working group was appointed to help remedy these abuses and enable the consumer to make more meaningful comparisons of different policies.

The group decided quite early to prescribe a standardized information form to be given to prospective purchasers of certain life insurance products. The group identified universal life, indeterminate premium, and variable life products for this purpose, but it stopped pursuing a variable life form when it was pointed out that product is extensively regulated at the federal level and that any new state requirements might duplicate or, worse, be inconsistent with federal requirements. After going through several drafts, a set of forms was adopted at the June 1989 NAIC meeting with the understanding that they would be test marketed for readability and any necessary changes would be made at the next major NAIC meeting six months later. The test marketing identified a number of troublesome areas, and some major revisions were incorporated into the forms that were eventually adopted at the December 1989 NAIC meeting. Now, let me describe the principal features of the forms and two major issues that arose during their development.

PRINCIPAL FEATURES OF FORMS

There are two forms: one for universal life and the other for indeterminate premium policies. I'll spend most of the time describing the universal life form since, because of the nature of the policy, it calls for considerably more information than the indeterminate premium form.

The first part of the forms contains identifying information such as the name and address of the company and the agent; the name, age, sex, and underwriting classification of the insured; and the name and form number of the policy. The universal life form then identifies whether the policy is a flexible or fixed premium policy and the amount of the first-year death benefit and premium. It then contains sections entitled "Your Policy Charges" and "Your Policy Credits" in which the mortality and expense charges and the interest credits under the policy are explained. Numerical values for those charges and credits are shown for the first policy year, both on a guaranteed and current scale basis. There then follows a section in which the following must be shown:

- The maturity age.
- Separately for the guaranteed scale and the current scale, the point at which the policy will terminate based on the planned premium amount.
- Using only the guaranteed scale, the level annual premium required to provide the first-year death benefit to the maturity age of the policy.

The form ends with a page entitled "Illustration of Policy Values" that contains a chart A and a chart B. These charts include the type of information commonly seen in sales illustrations, such as the premiums, death benefits, and cash values, both on a guaranteed and current basis. Chart A is the guaranteed basis chart while chart B shows the values on the current basis. The values must be shown for each policy year from one through 20, for every fifth policy year thereafter, and for years the insured attains ages 60, 65, and 70.

The indeterminate premium form is much simpler, primarily because charges and credits are not explicitly identified under these policies. The only unique feature of these

policies is the adjustable nature of the premium. The form describes the company's right to change the premiums, and the illustration page must show the premiums both on the guaranteed and on the current basis.

Finally, accompanying both forms are several pages of instructions for completing them.

MAJOR ISSUES DURING DEVELOPMENT

During the development of the forms, two issues dominated much of the discussion between the regulators and industry representatives. The most significant related to the point in the sales process at which the forms would have to be given to the applicant. For a long time, the regulators insisted that the forms be furnished no later than at the time the application is taken. It's clear that such a requirement would interfere significantly with the sales process. Much of the numerical information, particularly for universal life policies, cannot be furnished on the spot by the agent; it has to be developed at the company offices. You cannot, for example, imagine the agent on the spot figuring out the point at which the policy will terminate based on the current scale or the guaranteed scale, or the level annual premium required to carry the policy to maturity. Thus, if the forms had to be furnished at the time of application, an agent would usually have to make an additional call on the applicant before completing the sale. This would delay the point at which the insurance coverage could become effective and would add significantly to company costs. For direct response marketing, a time-of-application requirement is simply not viable, so these products could not be offered through direct response.

Fortunately, the regulators agreed to modify their position. The rules that were adopted provide that, for direct response sales, the forms can be delivered with the policy, provided the policy offers a 10-day free look period during which the policy can be returned to the company for a full premium refund. For other than direct response sales, that is, sales where agents are involved, the rules are more complicated and the regulatory language is somewhat convoluted. The forms must be delivered within 15 working days following the date of application, but at least five days before delivery of the policy, except that this five-day requirement is waived if there is a 15-day free look. What this means is that the forms can be delivered with the policy provided it contains a 15-day free look and provided that the policy can be delivered within 15 working days of the application. If the policy cannot be delivered by that time, the forms must be furnished at that point and the policy must follow afterwards.

The industry did not fare as well, however, with the other issue that received considerable discussion. That was the question of whether the information on the forms should reflect any riders for which the insured might be applying. The regulators believed that riders should not be included. They maintained that this would help ensure uniformity of presentation and make it easier for the consumer to compare the costs of different policies. The industry argued that the only meaningful figures are those for the specific policy, including any riders in which the applicant is interested, and that any other figures would only confuse and very possibly mislead the applicant. The industry arguments were to no avail on this point, and the forms must assume no riders. This means that, where riders are involved, the applicant will most likely wind up with two sets of figures:

one without the riders to comply with the regulation and the other with the riders to reflect the actual policy provisions.

INDIVIDUAL STATE ACTIONS

As indicated, the final forms were adopted by the NAIC in December 1989. This is but the first step along the regulatory path, however. With regulations of this type, NAIC adoption by itself carries no regulatory effect; nothing becomes effective until the individual states act.

To date, no state has adopted these forms. Why this complete lack of action after all the effort in developing the forms? One possible reason is that, during the early part of the year, state insurance departments are generally busy dealing with the legislatures, which customarily are in session then. Also, it takes a few months for new NAIC regulations to be officially published, distributed, and adapted for individual state use. Many states also have been occupied with more urgent concerns, such as automobile and health insurance rates and solvency questions.

I think we'll see in the next several months if there is going to be broad interest in adopting these forms. Some states are reluctant to be pacesetters, so it's not uncommon for action by one or two states to precipitate a chain reaction. We haven't seen any hint of real momentum, but I'll conclude with a generalization that is applicable in most political and regulatory situations, namely, that the one certainty is uncertainty.

Now we'll turn to you, Phil, and you can tell us about some of the exciting things we may expect in the future.

MR. PHILIP K. POLKINGHORN: I think we can expect that some of what's already happened will occur again in the future. Based on some of the activity, it appears that perhaps we haven't learned lessons from the past.

I'm involved in a project in association with the AAA Committee on Life Insurance to look at illustrations concerns. I should indicate that any opinions I express are my own and not those of the Academy or of other members of my group.

How did these concerns about illustrations manifest themselves? First and foremost, I think there has been a view that illustrations are meant to be estimates of future performance, rather than demonstrations of a product's performance under a given set of assumptions that may or may not be likely. We've seen a number of letters in *The Actuary* expressing concern over whether actuarial standards are being met with respect to illustrations and whether these standards are strong enough.

The research by the Academy Committee on Life Insurance started as a small project to evaluate the effectiveness of the NAIC interrogatories on nonguaranteed elements. It soon became obvious that the issue is of broader scope. A brief summary of the concerns about illustrations makes it clear that the problem has more than one facet to it. There is widespread belief that many of today's illustrations may not be supportable. Further, it's believed that tricks are used to enhance the performance of products that may not be understood by the buying public. Industry credibility is at an all-time low.

The consumer and financial press has picked up on the criticisms that insurance companies level at each other regarding the quality and credibility of their illustrations. Finally, it appears that standards are slipping, and that required written reports on nonguaranteed element practices and dividend practices have occasionally not been available on examination.

INSUPPORTABLE ILLUSTRATIONS

The most common complaint leveled against illustrations is that they are not supportable given a continuation of reasonably anticipated experience. This is exactly what one of the interrogatories in the annual statement was meant to get at. Usually the interest element is at question. The simplest and most common accusation made in competitive situations is that one company or another is projecting an interest rate that it cannot hope to earn over an extended period. This complaint is very difficult to monitor. It is not easy to segment a company's portfolio into blocks of assets that might support lines of business as widely diverse as participating whole life and group accident and health. In addition, the definition of insupportable is not really clear.

- Does insupportable mean that the company must make its target financial goals established at issue?
- Or does it mean that the company does not lose money on the product line prospectively from this point forward?
- Or does it mean that the company can support the illustrations as long as it doesn't run out of surplus?

Finally, there is concern that some of the product practices may place unbearable burdens on future management. Some products may be profitable at issue but provide little or no margin to future management. When management is faced with an environment that demands a 12.5% rate of return and the in-force block produces only 4-5%, there is little that can be done in new-business pricing to help it meet the overall goal. The temptation is great to manage the in-force block in a manner inconsistent with the way it was priced and sold.

POLICY ENHANCEMENTS

On examining this subject more closely, it quickly became obvious that an entirely different issue was arising quite apart from illustrations supportability, and that was the issue of policy enhancements. In much that has been written about illustrations credibility, policy enhancements have been prominently mentioned. Policy enhancements are features that have the effect of providing significant additional benefits to policyholders at selected points that are important in competitive comparisons. Examples include a retroactive interest bonus, a return of deductions previously made, and special scales of terminal dividends.

My personal view is that in many cases the policy enhancement issue is quite separate from the supportability issue. If costs and reserves for product enhancements are based on reasonable persistency assumptions, they're probably supportable. Opponents of these types of features argue that policy enhancements are not fair, and this appears to

be the true open question. Given the attention that policy enhancements have received, my view is that they'll probably all be provided and that something else will have to give, if necessary.

ACADEMY ACTIVITY

What has the Academy Committee on Life Insurance been doing? We're really just getting started, but we've isolated two areas for potential investigation. The first is the examination of standards, education, and communication. What actuarial standards already exist with regard to illustrations? Are these standards being communicated properly to the membership? Is there something better that could be done in the education process to help actuaries meet current standards? Second, it became obvious that, with regard to special policy features that may well be supportable, some combination of appropriate disclosure and smoothness testing on current values might be worth researching.

As I mentioned, our group started with a review of the interrogatories and found that the interrogatories did not seem to be adding the expected discipline to the illustration process.

- It's not clear that the interrogatories fully reflect or mirror the current standards.

- Responses made to current interrogatories could benefit from additional guidance in the form of written case studies or seminars on the topic.

- Additional interrogatories that are more pointed might get to the heart of the matter. There seems to be a fair amount of difference in the ways the interrogatories are interpreted.

Our group is divided into two subgroups, one of which will address standards and education. This subgroup will examine the current interrogatories and the responses to them; examine standards for nonguaranteed elements and dividends; suggest educational approaches that would help to communicate the requirements to the membership, providing case studies in certain situations; describe answers to the interrogatories that might be appropriate; and may also suggest more pointed interrogatories. Finally, the subgroup will address the review process. Who is responsible for reviewing responses to the interrogatories? Is it the Academy? Is it the NAIC?

SMOOTHNESS AND DISCLOSURE

We know that regulators are looking at these illustrations issues, and we identified two areas that might be worthy of advanced research. First, if you accept the principle that guaranteed values must be smooth, as is required by the Standard Nonforfeiture Law, you might also accept the principle that current values should meet some sort of smoothness test. Therefore, our group will examine potential smoothness tests for current values. A problem arises in determining what type of test makes sense, and we would welcome any rationale for what level of smoothness is good and what isn't. The current test for guaranteed values appears to have little rationale. Finally, what should be done if a policy fails a current value smoothness test? Should the policy be

considered deceptive and not permitted to be sold? Should additional disclosure be required? Or would it be better to limit the illustrations to values that meet the smoothness test?

Under a bright line test on smoothness, a steep values policy may have higher current and guaranteed cash values at each and every duration than a smooth values policy but would be prohibited solely because of not being smooth. This would be illogical to agents and probably also to customers and policyholders. Chart 1 illustrates this point. Both of these policies meet the standard minimum requirements, but the steep values policy might fail the smoothness test.

Under a special disclosure approach, companies would have to identify separately any additional illustrated values that are due to special features that cause the policy's cash values to exceed a smooth set of values. This example is purely hypothetical, but it illustrates the point (Table 1). The company would show a regular illustrated value that meets the smoothness test and the total value. The balance would be the additional illustrated value and might have to be footnoted to alert the policyholder to check the policy value at all durations because an unusually large portion of the policy value is developing only at certain durations.

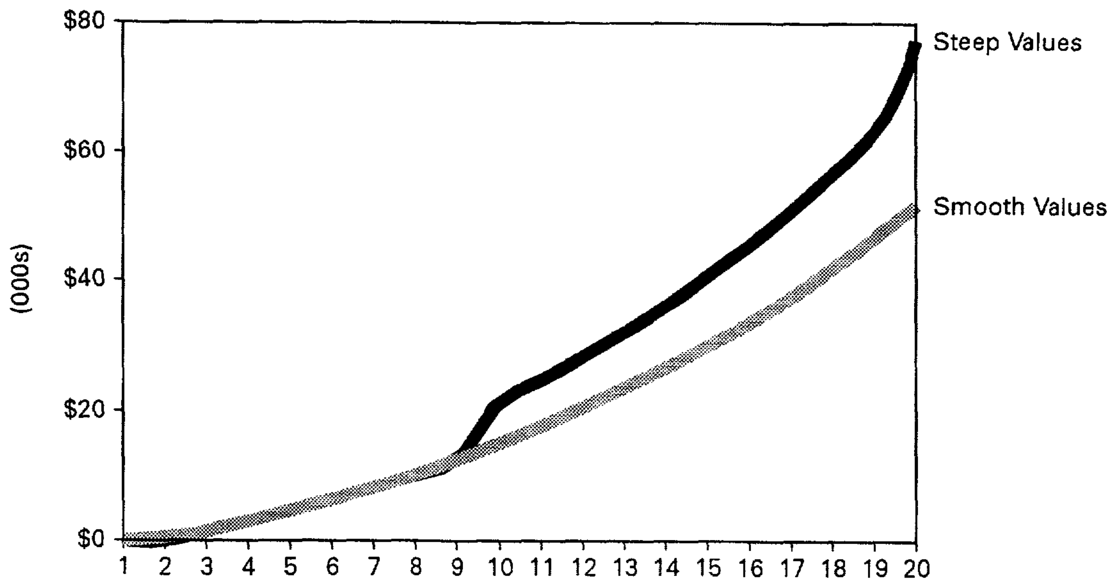
TABLE 1

Year	Guaranteed Cash Value	Regular Illustrated Value	Additional Illustrated Value	Total Value
1	0	0	0	0
2	0	0	0	0
3	1,075	1,474	0	1,474
4	2,385	3,067	0	3,067
5	3,681	4,738	0	4,738
6	4,957	6,485	0	6,485
7	6,205	8,312	0	8,312
8	7,422	10,250	0	10,250
9	8,601	12,621	0	12,621
10	9,731	15,154	6,386	21,540
11	10,800	17,864	7,066	24,931
12	11,794	20,767	7,826	28,593
13	12,456	23,638	8,675	32,313
14	13,003	26,736	9,628	36,363
15	13,411	30,080	10,698	40,778
16	13,653	33,700	11,903	45,602
17	13,706	37,627	13,263	50,891
18	13,539	41,904	14,803	56,707
19	13,122	46,577	16,550	63,127
20	12,410	51,702	25,657	77,359

There are some concerns on the other side, though. There is a risk that too dramatic an action would unnecessarily standardize products.

PANEL DISCUSSION
CHART 1

Problems With Bright-Line Tests



This seems especially objectionable given that the most commonly perceived abuse is illustrating a higher interest rate than the company can support.

Our group is just getting started and, if you have ideas that have been bouncing around in your companies or local actuarial clubs that you believe might be useful, be sure to contact me.

MR. SPANO: We'll now open it up for questions.

MR. WILLIAM M. WHITE, JR.: Everybody is focusing on the elements of the contracts, and yet, with the advent of the personal computer and the freedom to run all types of illustrations, I'm concerned that there is inconsistency between allowed administrative practices and what agents are really showing in illustrations. I think that needs to be addressed by the Academy. I don't think you can take care of that in the disclosure forms.