RECORD OF SOCIETY OF ACTUARIES
1991 VOL. 17 NO. 2

DISCLOSURE SYSTEMS: CAN AN IDEAL METHOD BE FOUND?

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Within the life insurance industry, there is increasing skepticism as to whether illustrations of projected policy values will be met. This session will discuss the "Illustration Problem."

- Are current disclosure standards inadequate?
- Is the "Illustration Problem" real?
- Is it possible to design an understandable method which cannot be manipulated?
- What responsibilities do actuaries have in developing adequate standards?
- NAIC activities
- Risks in improper disclosure
- Need-based versus product-based disclosure
- Controlling PC illustrations

MR. ROGER R. HEATH: We will be discussing the extent of the illustration problem, the responsibility of the actuarial profession for the illustration problem, and potential solutions to the illustration problem. We will not be discussing all the different kinds of enhancements to universal life and participating plans. You will not come away from this session knowing one more way that your competitors are "lying" with illustrations. What we intend to do is to spur some discussion so that, to the extent the profession wants it, we can take action moving forward.

BACKGROUND

How did the industry, in the 1980s and 1990s, get into a situation where it was selling illustrations instead of value?

Chart 1 provides a macro look at the life insurance industry. It shows sales method, group versus individual; type of protection, life and health; and degree of savings, investment (high savings), savings (moderate savings), and protection (little savings).

Investment consists of all annuities and single-premium dump-ins from universal life. Savings consists of whole life products and periodic premiums of universal life. Protection consists of term-type products.

What we see is that over the last six years or so, the life insurance industry has had a very high increase in real premium growth in the investment elements, both individual and group, and in the protection element for health insurance. But both life protection and regular savings growth, in real dollars, has been flat. The industry has not been growing with its premier product, whole life.

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CHART 1

Real Growth in Premium Income

- Investment--high
- Health protection--good
- Life protection, regular savings--flat

Real Growth of Life Industry Total Premium Income

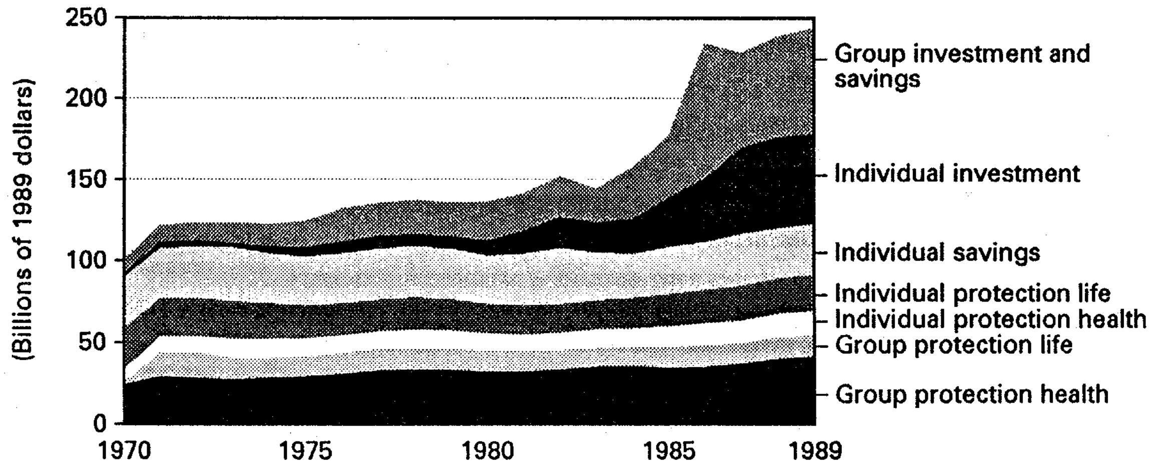


Chart 2 shows that market share for the insurance industry, as measured by personal assets held by intermediaries -- commercial banks, thrifts, the insurance industry, mutual funds, money market funds, credit unions -- has dwindled since the 1970s. In the 1970s, the insurance industry had a 20% market share of assets. This has been slowly tapering off, although in the last four to five years, the market share of life companies has increased slightly.

However, if we look at Chart 3 a little more closely, we see that the market share of regular savings has continued to decrease, and what's actually increased over the last five years has been investment business -- annuities and universal life dump-ins.

Thus growth in premium income is flat and our market share by assets held has been decreasing. To make matters worse interest rates have been steadily declining which makes selling to the consumer difficult. This led to enhancements on at least one kind of product, universal life. (See Chart 4.)

Chart 5 shows that in 1988, of 240 products, 26% had enhancements. In 1990, 52% of all products studied had enhancements.

Table 1 shows the various types of enhancements and their distribution. The first enhancement increases the credited rate at a particular point in time. The second enhancement is essentially the same except that the increase is triggered by an amount. The next two credit additional interest retroactively, to reward persistency. The final enhancement results in a refund of all cost of insurance charges at a particular point in time.

TABLE 1
Distribution by Type of Enhancement

	1988	1990
Stepped credited rate by duration	23	62
Stepped credited rate by trigger amount	10	14
Tiered credited interest rates	9	19
Retroactive crediting of interest	7	6
Lump sum distribution bonus	10	24
Total out of 240 products	59	125

There has been an economic circumstance that has driven insurance companies to want to sell more. They've responded by providing policy enhancements. But have they really started selling value to customers?

I have come up with an index that's based upon a mathematical expectation that includes looking at the death benefits and the surrender benefits paid by an insurance company each year to a group of policyholders, and the time value of money. After calculating the index for 240 universal life products in the marketplace, I compared their value index with their 20th-year cash value in a scatter plot. (See Chart 6.) I wanted to see if the life insurance industry's focus on 20th-year cash values is a focus on value to the policyholders.

CHART 2

Market Shares of Personal Assets Held by Intermediaries

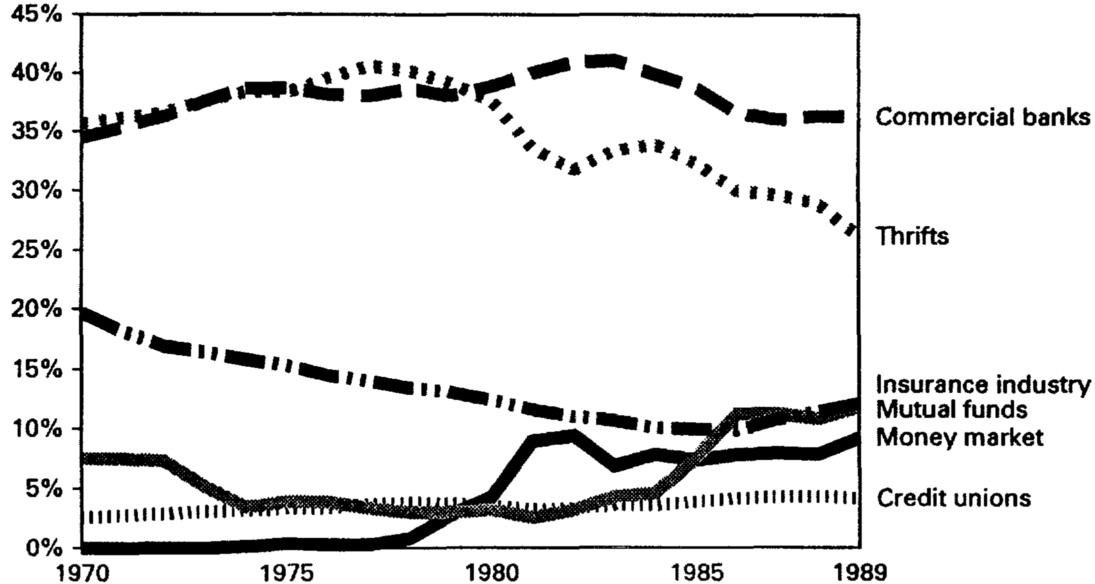
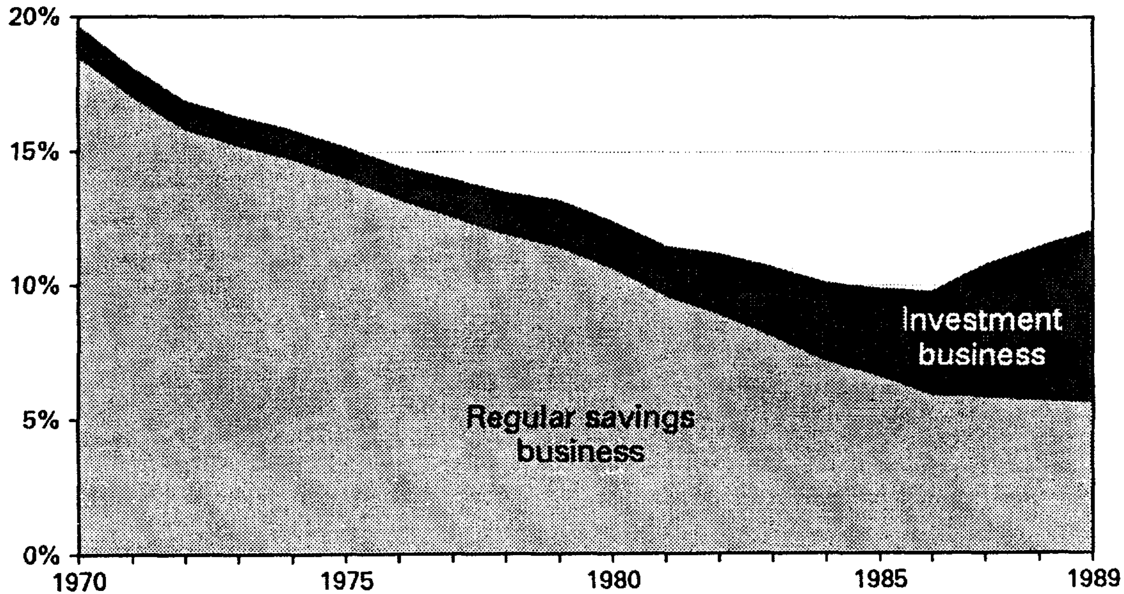


CHART 3

Decline in Life Industry Share of Personal Assets Held by Intermediaries



PANEL DISCUSSION

CHART 4

Interest Rate Trends

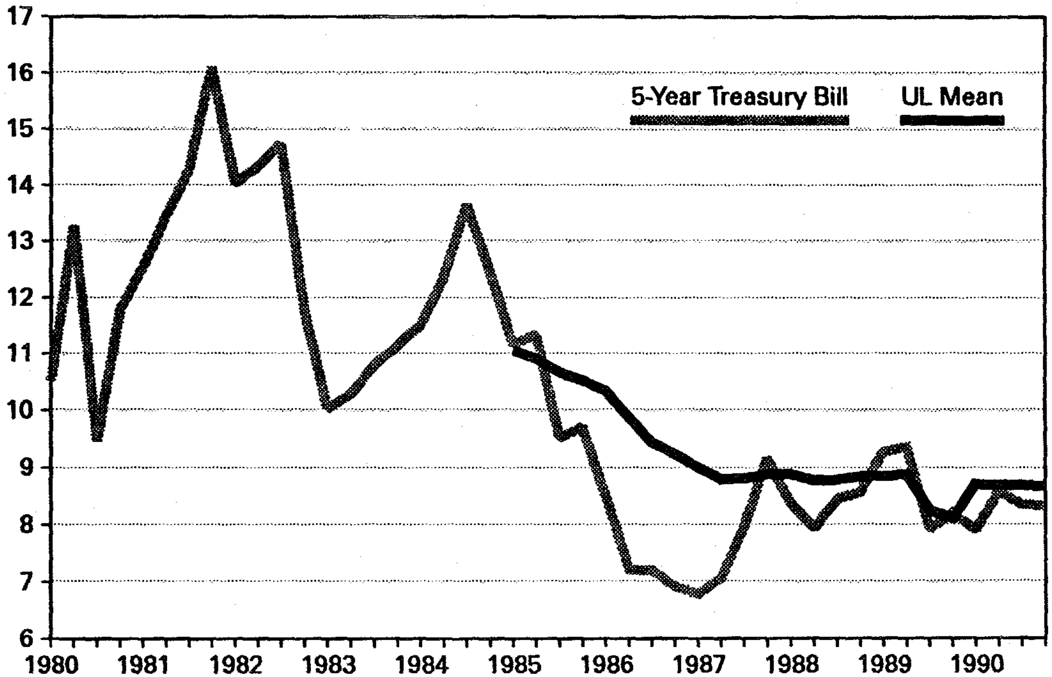
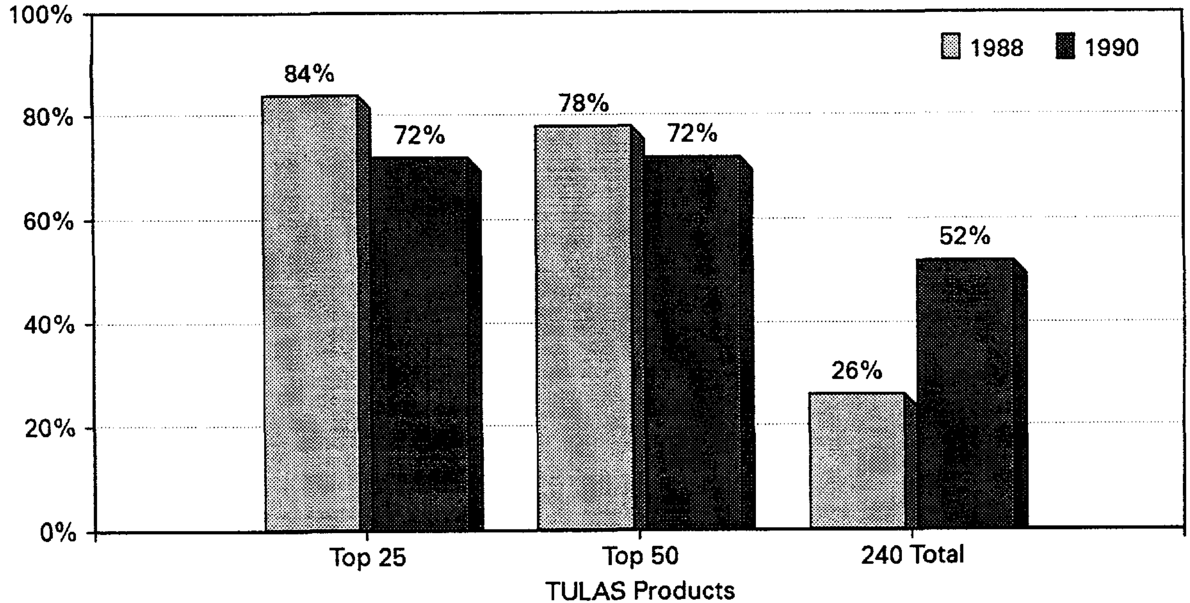


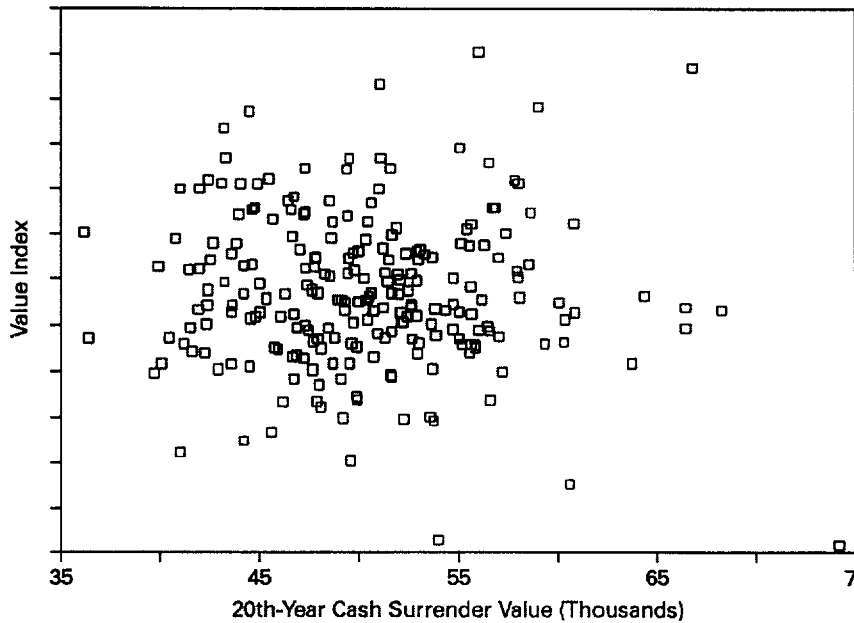
CHART 5

How Prevalent Are the Product Enhancements?



Based on 20th-year cash values.

Can We Tell the Value From the 20th-Year Cash Value?



If cash value were a good indicator of value, you'd expect to see pretty much a straight line from the lower left to the upper right. Instead what you see is almost a random scatter. In fact the correlation coefficient is slightly negative. My conclusion was that you can tell absolutely nothing about the value of a life insurance product by looking at the 20th-year cash value. You could almost choose at random and get as good a choice.

Given that background, I would like now to have our esteemed panelists address the first question: Do you regard the "illustration problem" to be such that it's time for the industry and the regulators to take more dramatic action? Specifically, I asked them to address: What harm has come from improper use of illustrations, and to whom?

Do today's illustrations of new plans pose the potential for a higher order of abuse? Has the regulation proved helpful in policing improper illustrations? Does any segment of the insurance industry, or does any particular product, promote abuse?

MR. WILLIAM C. KOENIG: It is clearly time for action. I admit to being dismayed by the disarray in the market, as a result of "illustration games."

When my kids go outside to play games, I let them do so with the expectation that no one will get hurt. With some of the illustration games being played today, my expectation is exactly the opposite. I say that for two reasons, one of which is historical, and one of which is practical.

On the buyer's side, there are two major sorts of harm that can befall the unwitting participants of illustration games. Neither is trivial.

1. Bad buying decisions are more likely to occur. Bad buying decisions are inevitable whenever illustrations are not on a comparable basis. The existence of illustration games exacerbates the problem.

2. The misdirection of an illustration game can leave the buyer in a position from which he simply cannot recover.

One of our competitors likes to talk about an illustration where a big premium increase at an advanced age is downplayed by saying, "Don't worry, you'll probably be dead by then." He calls it the pay-or-die illustration. How can we expect an 80-year-old individual, who has been paying the level premiums illustrated for years but still finds himself out of cash and insurance, to replace what he thought was a permanent benefit?

The life insurance industry will also suffer because of illustration games. It suffered once before when unsound illustrations were prevalent -- 100 years ago during the tontine wars. That is my historical reason for saying that both buyers and the industry will be hurt by unsound illustration practices.

Let me go back in time now, and try to retrace our steps from the tontine days to the present. Tontine policies were first introduced by the Equitable, in 1867, without dividends or surrender values. In 1871, semitontines were introduced, and were instantly popular. Competition among the big three, Equitable, Mutual of New York, and New York Life, was said to be ruthless, and smaller companies struggled to survive in their shadows.

In 1881, after over 10 years of arming its agents with arguments against the tontines, my company, Northwestern Mutual, debated the wisdom of entering the fray. The agency guy took the affirmative. The company secretary took the negative. The actuary, Emory McClintock, in the days before he moved to the Mutual of New York and enjoyed his illustrious career, it is said, "spoke on both sides of the question showing the advantages and disadvantages." (*Northwestern Mutual Life: A Century of Trusteeship* by Harold F. Williamson and Orange A. Smalley, Northwestern University Press, ©1957, p.102.)

By the late 1890s, the bloom was off the tontine rose. There was a growing disparity between the estimates made to buyers, and results to survivors. Even when a determined and conscientious effort was made to keep agents' claims (illustrations) within bounds, policing a far flung agency force was difficult, especially in the face of vigorous competition. The Northwestern Mutual 100-year history says, ". . . to restrain the selling force from making overly optimistic claims for these policies, particularly when professional actuaries were unable to make precise estimates, was not an easy problem." (op. cit.)

It goes on: "Even the more modest claims for this type of policy proved to be misleading because of two trends . . . : one was the increasing life expectancy in the United States, the other the continued fall in the rate of interest. . . . [O]ver longer intervals survivors ultimately collected much smaller dividends than they had been led to expect." (op. cit.) This sounds eerily like the situation today.

The tontines contributed to the Armstrong investigation, and the Armstrong investigation spelled the end of tontines by requiring an annual distribution of surplus. The entire industry was tarnished. I have a file of irate letters addressed to our chief actuary from years later, expressing unhappiness.

The good news was that a new discipline was imposed on company dividend practices. Mutual company actuaries became proficient at ever-more precise allocations of surplus based on current earnings. They spent endless hours debating the characteristics of equity, and how it should be applied in various situations. When interest rates spiked in the 1970s, the mutual companies' ability to offer their buyers "participation" became an increasing advantage, and nonparticipating contracts' guaranteed lower gross premiums became a weaker selling point.

Then, the concept of what I call "pseudo-participation" was introduced for otherwise nonpar contracts; e.g., universal life and excess interest or current assumption whole life. The main difference between participation and pseudoparticipation, is a lack of any requirement for equity in the latter.

About this same time the baby boom generation hit the insurance industry, both in the ranks of agents and actuaries, bringing with it a lack of any memory of harder times.

Computers made the calculations that go into an illustration a manageable effort for anyone, actuary or agent, and the unbundling of products made the calculations understandable, and thus more prone to manipulation. Increasing interest rates made optimistic estimates seem realistic, and to the extent the 1980s were a decade of greed, a buying public hungry to believe that they could become rich on pennies a day was an easy target.

So where are we today? Older illustration problems are still with us; e.g., investment-year method versus portfolio method. Although not abusive, this difference in interest crediting methods certainly causes comparability problems.

More and more companies, both stock and mutual, are being forced to pull out the stops in order to compete. The definition of "current experience" is being stretched to include trends and even "wishes." Marginal pricing is apparently now an accepted actuarial technique, at least according to the program for this meeting.

Finally, the tontine is back in the disguised form of "lapse-supported" products. Two years ago I thought it so unlikely that we would be foolish enough to resuscitate this failed strategy that I would have been reluctant to make such a statement. But now companies speak with pride that their scales are so solid they can even tolerate "somewhat lower lapses." Well, they had better be ready. If they are successful selling to an upscale market, those individuals buying survivor life policies for estate tax needs will not walk away from their $10 million policies like they might a $5,000 whole life policy in a more down-scale market.

Do today's illustrations of new plans pose a potential for a higher order of abuse? Darn right. Frequently, neither agents nor buyers understand how products work, nor do they understand the nonguaranteed nature of dividends or "current charges," nor the pitfalls that may occur at durations beyond those shown in the illustration.

Moreover, they are buying and selling mega-amount single contracts, that would have made a good sales month not so many years ago, to people with attorneys and advisors and tax problems that will still be there, even if the policy values are not. They will not be pleased.

As for regulation proving helpful in policing improper illustrations, I think the actuary's ingenuity, together with computer power, allows for product innovation that outstrips regulators' ability to keep up. In other words, I believe regulation has been, by and large, ineffective.

Does any segment of the industry or type of product promote abuse? I was originally going to say no to this question, until I began to prepare my remarks, and realized that perhaps it is this "upscale market" where big policies are the norm, where excesses are the greatest. Just as in the 1890s, where the competition is most vigorous, the incentive to stretch the boundaries is the greatest.

This leads me to my practical reason for why I believe harm has come, and will continue to come, to buyers, agents, and companies from improper use of illustrations. Where there is great money to be made there will be great competition. Boundaries will be stretched, and there are incentives to go closer and closer to the edge of the cliff. Sooner or later, someone will fall off. In one sense, the Executive Life situation is an illustration problem, since it was the illustrative appeal of high interest rates that justified the high-risk investment strategy.

The solutions to these problems are not at all clear. I will say that a requirement for equity, as generally defined by the contribution method of dividend determination, is a worthwhile constraint. The most egregious examples of lapse support are precluded from companies that profess to give early terminators their fair due.

Fortunately, there is some glimmer of hope on the horizon irrespective of regulation, or actuaries, or company ethics. The well-advertised failures of some of our most aggressive companies has cast a pall over promises of riches. There is a healthy, if tentative, shift away from looking at illustrations as if they were the product, and an increasing willingness to look at company practices, management, and history as other important parts of the purchase. As the buying public becomes more skeptical, the rhetoric frequently used to justify aggressive illustrations becomes less credible, and the beneficiaries are companies that can point to their reasonable illustrations with a simple explanation, "This is what we illustrate because this is what we are paying, on all in-force business." I have heard of a financial advisor who will look at a number of proposals and begin the weeding-out process by tossing out the low and the high. More stories like these will reduce the incentive to inch toward the cliff to all our benefits.

MR. WILLIAM D. BALDWIN: As part of my preparation for this session, I tried to find a quotation I saw cited in the *Record* several years ago. It noted that actuaries had come to look upon the computer as the big THINK, allowing them to produce technically elegant products in a matter of a few months. However, it has been proven that the computer, in the hands of an agent, becomes the big FINK, for within a few hours he can find all the holes in that same product.

The insurance industry offers promises as their product. We ask people to give us some money now in exchange for what we will do for them upon certain events in the future. As such, there has always been plenty of room for abuse whether through acts of commission or acts of omission. Is it worse now than ever? Let us not forget Lorenzo Tonti, the Neapolitan banker, and his clever schemes in the seventeenth century. I think he would admire some of the persistency bonus plays of today.

Not withstanding the potential for abuse, the illustration is one of the more useful tools we have available to help a prospect understand what he/she is buying. Illustrations have tremendous utility and is an industry resource worth protecting. After all, abuse during the sales process has always occurred and has not been limited to the illustration process. In fact, one common abuse is the nondelivery of an illustration when one is called for. Thus, I think we need to keep in mind that the illustration problem is really a "technologically enhanced sales process" problem.

Do today's illustrations of new plans pose potential for higher order abuse? I believe the answer is yes given the pressures of the modern illustration environment:

- Growth of interest-sensitive, flexible products -- evolving to heavily back-end loaded forms.
- High double-digit interest rates in early 1980s -- trending steadily downward.
- Low cost microcomputers with massive power -- very friendly to use.
- Continuing regulatory & legislative pressures.

These conditions have created intense and continuing pressures on companies and on agents and brokers to maintain a competitive position in their marketplace. The "price" to the consumer became the focus, and that price often is represented as a particular value at a particular point in time. As interest rates fell, it became more and more difficult for new products to have values that were as good as, or better than, the previous product. In trying to meet sales goals, some companies turned to inventive new ways to enhance their offerings. If they could not come up with a better product, the next best thing was to develop a better current illustration. Besides, illustrations are generally quicker to produce and one does not have to deal with those messy state filings.

Examples of variations in illustrations:

- o High interest rates projected for the life of the policy
  - higher than the current rate
  - current rate subsidized.
- o Projecting significant mortality improvements.
- o Manipulating older age mortality rates, especially for paid-up values in "vanish premium" policies.
- o Unguaranteed (and often undisclosed) persistency bonuses.

The above is extremely easy to put together a misleading proposal illustration; but how serious is it? The following tables demonstrate the effect of varying assumptions on the same product. The effect is measured by the premium level necessary to pay up the policy for the stated payment period.

We see that an agent can present a much better deal for his prospect with just a little help from his company. When a buyer is presented a "superior" buy based on complex illustrations bound in an elegant folder he/she might conclude that the scenario presented could reasonably be expected to happen. Instead he may be getting a notice in just a few short years that his premiums need to increase to keep the policy on track to pay up. (See Table 2.)

TABLE 2
Effect of Variations

Key Assumption	Yearly Premium Index	
	20-Pay	5-pay
8% Level Interest	1,000	1,000
9% Level	878	805
9, 9.25, 9.5%	841	770
9%, 1/2 COIs after 65	742	680

Table 3 simply reverses the reference point from the chart above. We see that substantial premium increases could be needed to complete the original program of insurance. How many illustrations have we seen that make this clear to the prospect?

TABLE 3
When Assumptions Aren't Met

Assumption	Premium Multiplier	
	20 Pay	5 Pay
9%, 1/2 COIs after 65	1,000	1,000
9, 9.25, 9.5%	1,134	1,132
9% Level	1,183	1,185
8% Level	1,470	1,347

It is not obvious that one particular product type versus another is more conducive to misrepresentation. We tend to point our finger at the more obvious ones -- corporate-owned life insurance (COLI), split dollar, or perhaps the old minimum deposit illustrations which often failed to include a net death benefit column. Two-tiered annuities remind us that all product types present opportunities to mislead.

Permanent life insurance products (traditional whole life as well as back-end loaded interest-sensitive) have historically utilized the techniques of persistency bonuses. The nonforfeiture laws say that a particular persistency bonus is OK by providing expense allowances up-front and then attempting to control the tontine effects through the smoothness tests. In question though are the enhancements that are outside these "norms" that make comparability difficult if not impossible.

When these persistency bonuses are actually disclosed, they are explained as penalizing early lapsers with the money being passed on to the persisters. Since these nonguaranteed enhancements are not subject to reserve requirements, the lapse penalties are available for whatever purposes the company chooses and arguably are a very efficient way to raise capital. These lapse profits could also represent a source of dividends (policyholder or shareholder) leaving future management a dilemma if more people stay around for these enhanced values.

MR. HEATH: The next questions to be addressed are, "What responsibilities do actuaries have? Do they have a responsibility to promote regulation, or legislation, or to oppose such action? Do answers differ, depending upon whether actuaries are employed by insurers, by consulting firms, or by governmental agencies? What part of the actuarial profession, or what other professional bodies, should play a role in answering these questions?"

MR. KOENIG: Actuaries do have a responsibility to deal with these questions, if only for self-preservation. Rightly or wrongly, we are thought to be the brains behind the insurance operation.

I believe we have a responsibility to deal with these questions because we seek to be a profession. If we wash our hands of this issue by claiming that our only responsibility is to disclose to company management the actuarial niceties of the illustration assumptions, their implications, etc., then we are admitting that we are merely mechanics taking mathematical orders from our superiors without regard to our ultimate public, the buyers of our products. In my opinion, these buyers give actuaries 99% credibility (even if they only have 1% visibility). I have already seen examples of marketing pieces that defend the company's illustrations as having been reviewed by an actuary, and found to be reasonable. The public does not understand the distinction we are tempted to make in our own minds, that the product of our efforts, upon which we are judged, and for which we need standards, is presented to an intermediary who can do whatever they want with our work. We cannot pretend to be a profession if we seek to distance ourselves, and the standards imposed upon our work, from the products that are ultimately delivered to a trusting public.

Medical doctors are a profession. Their responsibility extends beyond informing and disclosing to their clinic's management that new medical techniques exist, etc. The clinic cannot tell the doctor to prescribe sugar capsules instead of medicine, because it's cheaper and the patient won't know the difference until it's too late anyway. The doctor will quit. Why should actuaries be willing to create illustrations that are designed to disappoint, even with disclosure to management of the situation? Somehow, if we are in fact to be a profession, the link between actuarial practice and consumer product must be strengthened.

Let's go back to lapse-supported pricing. How does it work? The funds that are left over from the "early terminators" -- say, anyone who terminates in the first 15 years, which may be 80-90% of your expected buyers -- go to the "persisters," the 10% or 20% who are still around 15 years from now.

When I first learned of these practices, I made a presentation to my boss to explain what lapse-supported pricing was. At the end of my presentation my boss looked at me and said, "Well? What are the actuaries going to do about this?" It was totally natural, in his mind, that the actuaries, who have the control, would devise the solution.

And I had to tell him, "I'm not sure the actuaries are going to do anything about it because frankly, the people who are coming up with these schemes are probably getting big raises and nice promotions, and they don't have much incentive to scale back. If sales are made based on the assumption that only 10% will be long-term persisters, the inevitable result is that 90% will be disappointed because they had intended to be part of the 10%.

A car salesman could not advertise a picture of a Lamborghini, and put it in a box, and then have customers come in and pay for the Lamborghini, only to realize later, that only one out of ten buyers really got a Lamborghini, the other nine getting an old Nash or Volkswagen. They would have to disclose that it's a lottery, and that if you are unlucky, you get the Nash. You have to be lucky and a survivor to get the Lamborghini.

There is also a gambling analogy. You can go to Las Vegas and invest a quarter. But the casinos don't tell you that everyone who invests a quarter is going to win a million dollars on the slot machine. There's an explicit understanding that many people leave their quarters in the machine. Most people who go to Las Vegas understand that they are not going to come back millionaires, and that they are going to have to leave a lot of quarters to pay for those few who do become millionaires.

A possible solution is to disclose to the public the mechanism and assumptions behind the illustration. We could disclose that for every one person who survives the 20 years to get the big payoff, there are nine who will not get that payoff.

Companies should have an obligation to explain the downside, the low early cash values, and the fact that the company is relying on many people to take those low values in order to fund the long-term bonuses. Companies should have to explain what happens if experience changes.

Among the worst examples are those illustrations that look to be lapse-supported, but are explained as being due to newly-rigid underwriting, low expenses, etc. This is the opposite of disclosure. This is active misdirection.

This is a long-term business. The mistakes we make will live with us, and they will live with our successors. When we sit at our computer terminals, with the asset-share program blinking wildly, and we push down early-surrender values and later ones pop up, we must ask a few questions before we hit the print button and run over to the agency department.

Will buyers' behavior change, especially if we use the new product in a new market, and sales are made specifically with these long-term values in mind? When I started out as a student at Equitable, not only did we study for the exams, but we spent a lot of time sitting around, playing a game that I now call "What if." We talked about how people's behavior, and how the products, would change if certain parameters changed, recognizing that life is not an asset share. I hope students still play that game today.

The actions we take today will reverberate for years. I think consultants have the same obligation to be concerned about the ultimate buying public as do company actuaries. I think government actuaries should also be willing to stand up to the industry and say, "Some things have to change." The importance of the nonforfeiture law and the work on it that's going on now cannot be underestimated. It must address the packages that are sold, the form of what is sold. When something is sold as a level-premium permanent policy, it should have cash values. The Academy of Actuaries must be decisive. If it is to do its work, it cannot design standards where all current practices are OK. I do not think that there need to be two sets of standards, one for dividends and one for nonguaranteed elements. The public certainly doesn't understand the difference between a nonguaranteed element and a dividend. If the main difference is that there's a lack of need for equity in the one, then that should certainly be disclosed as part of the nonguaranteed element package.

In closing, I'd like to say that just this week I got a document in the mail -- a draft code of professional conduct. I haven't had a chance to read it all, but I think it's terrific, and in fact, item six talks about control of the work product. Precept nine states, "An actuary shall not perform professional services, directly or indirectly, when the actuary has reason to believe that they may be used contrary to public interest or to evade the law." I think that's a wonderful thing (though subject to interpretation). It's certainly the first time I've seen anything that links the actuary to the ultimate buyer of the product.

MR. STEVEN A. EISENBERG: One of the problems I have with actuaries taking an advocacy position is that we really aren't advocates. We are trained professionals working on behalf of our clients. I cannot picture myself, as a consultant, being asked by a client to design a product, and to make this product better than the one being sold by company XYZ, and my saying, "Well, I'm not going to do that because it's not in the public's best interest." What I am going to do is tell my client what the pros and cons are of the other product. I'm going to go ahead and use our creative abilities to try and come up with something that will allow us to have a product that can be sold to the public. I'm not being retained by a consumer, at least not as a consulting actuary, and I don't think most actuaries working for insurance companies are either.

I think there are two exceptions – actuaries working for government bodies, and consulting actuaries who work on behalf of corporate clients in the employee benefits area. Other than these exceptions, I do not think that we are able to do something that may not be in our client's best interests (after all that's who pays our fees and/or our salaries). I think our responsibilities can be to educate our clients and our management as to what's happening. I don't think we can refuse to do what our clients ask us to do.

From a practical perspective, what am I going to do if I'm asked to develop a product and help with the illustration, and I can't come up with something that is competitive without having a bonus of some kind? I think education and disclosure are the things that we can accomplish, not from an advocacy perspective, but purely from an educational perspective.

Northwestern Mutual might say, "We want you to develop something better than the other products on the street." As a product development actuary, you are going to need to have some kind of interest enhancement such as higher crediting rate in the later years. Can you refuse to do what your company management asks you to do?

MR. KOENIG: We certainly have been in situations where we have looked at other illustrations and wondered why, considering Northwestern's good mortality and good persistency, etc., our contracts had trouble stacking up. Fortunately, I have not had to face the situation described by Mr. Eisenberg. I think that disclosure should be key if we have to do unusual things. If there was enough disclosure in the illustration, that would certainly help the actuary's position with the ultimate buyer.

MR. BALDWIN: Let me share an experience I had back when I was a consultant. There came an occasion where a client company asked me to do something, about which I felt very strongly that it would be neither right, nor appropriate, to take that action. To cut a long story short the end result was that the client opted for another consulting actuary.

MR. HEATH: We've addressed two questions now: Is the problem a problem, and are actuaries responsible or culpable? The last questions are: Can adequate and effective standards for directing the illustration process be devised? Can a static set of standards properly address new plans? Could new plans circumvent existing plans? How can actuaries help in finding the proper answers and the proper professional approach to the situation?

MR. BALDWIN: I'd like to answer the third question first: Can new plans circumvent existing standards? Yes. Second, I'd like to answer the second question: can a static set of standards properly address new plans? No.

In devising standards, the first order of business for all those bodies that intend to get involved in such activities is deciding who gets to define adequate, and who gets to say what is effective. These are subjective terms, but by asking the question, it certainly implies that whatever standards may now exist are either inadequate or ineffective, or both.

As we start trying to devise these standards, one of my fears is that we're likely to focus more on the symptoms rather than the "disease" that brings about the illustration problem the industry now faces. I think part of the problem is a lack of fiduciary responsibility and accountability for these documents. To continue this free-for-all invites a preemptive strike by regulators, and stringent guidelines that have little regard for the nature of the product.

I suggest that such accountability lies with the actuary and it is up to our profession to make responsible progress in this area in a timely fashion. I believe appropriate and understandable disclosure to the prospect can be achieved with the actuary's involvement.

MR. EISENBERG: Can adequate and effective standards for directing the illustration process be devised? We certainly cannot do that as a profession. I do think that perhaps the government could set standards. I think this has been done reasonably successfully in the variable life/variable annuity area with the SEC regulations. These regulations do not allow you to illustrate an interest earnings rate above 12%. They also require you to show 0% interest. It was not the actuaries who implemented the variable life limitations, it was done by the government. I believe that our role can be to analyze the practices that are going on, to educate the government as to what is happening, and to present alternatives. I don't think the actuarial profession is going to be able to have much impact. We don't control the sales process. We're not the people on the street actually selling this product, and our paycheck is generally not based on how many sales are made. There has to be a much higher intervention in order to tell a salesman what he can and cannot show.

One of the things that was mentioned earlier was having reserve requirements. That may be an area the government could regulate by requiring that a reserve be set up for each item illustrated.

Another thing that we can do is encourage the illustration of company capital and surplus to demonstrate the likelihood of a company being around 30 years from now to pay its obligations. That may be the only thing that we can do; encourage our clients and the government to require more information about companies. One needs to keep in mind that for companies with low ratings, companies that are not in particularly good financial shape, the only thing they can sell is a good-performing product, since they're not going to be able to sell themselves. Assuming they have actuaries and marketing people, they are going to find ways to sell those products, and I think there are always going to be opportunities for abuse.

MS. BARBARA J. LAUTZENHEISER: One of my major concerns is that we, particularly we actuaries, have continued to place the value of the product on specific numbers at specific points in time. This automatically takes us back to looking only at the savings element of the insurance contract. As was indicated earlier, it appears that the savings element is what we are selling. I sense that we have lost the death and annuity protection values of the contract. I'm not sure we are selling insurance benefits as much as we are selling investment benefits.

I have several concerns about this, mainly because I think that the public needs insurance and annuity values more now than ever before. When I hear numbers like 20% of those age 65 in the year 2000 are not going to have children on which to rely for either financial or physical support, they are going to need those annuities to provide those benefits. We have not used annuities as payout values much in the past; now we need money out there to do that with. This means we should be emphasizing both the death and the annuity protection of our contracts. But it's that protection element that we're not paying attention to.

The problem of the 1890s was surrender values. The problem of the 1990s is persistency of those products and encouraging people to buy and to stay. They should be buying protection, not an investment they expect to make a good return on in five years or seven years or ten years down the road. I haven't seen many contracts that really do provide cash values that reflect true equity in the early years. Almost all of our cash values, as a result of the standard nonforfeiture law, pay out values in excess of what the actual values are. My question is, Are we not now having lapse-effected, not necessarily lapse-supported, but lapse-effected contracts paying too much in the early years and not enough in the later years to those people who do keep the contracts?

Have any of you taken a look at the latest draft of the Standard Nonforfeiture Law? Section 15 is literally talking about regulating illustrations through the Standard Nonforfeiture Law; it is not only talking about regulating illustrations, it is also talking about restricting product design. In an environment where our demographics are changing so dramatically, we should be doing things to try and promote innovative design rather than discourage it.

My bottom line, as I think I've heard the panel say, is to utilize disclosure, rather than standardization of contracts. My fear from a regulatory standpoint, is that this is not what is occurring. Look at what is regulated right now. Medicare supplement contracts have a regulated commission structure, and products have been standardized. We now have 10 standardized long-term care products that have been designed by the federal government. My fear is we'll end up with x number of standardized life insurance contracts, whether they fulfill the policyholders' needs or not. So, as we're developing an illustrations policy or process, we have to emphasize disclosure and minimize standardization.

I'll end with one caveat that is a personal anecdote. Back in 1982, at the Phoenix Mutual, I helped design a graded-premium whole life contract. In 1983, when it looked like unisex could pass in spite of our efforts, I bought one of those for a half a millon dollars of coverage. In about 1986, when my cash flow got a little tight in my consulting practice, I went back to my life insurance contract to borrow on the cash value. Much to my surprise, having even designed the contract, I had no cash value on my graded-premium whole life contract. I said, "When do I have a cash value?" and they said, "In the fifth year." I said, "How much in the fifth year?" and they said, "$10,000." I said, "Nothing before?" and they said, "Nothing before." Now I considered suing the company for misrepresentation, but thought they'd pull me as a witness for having designed the contract. The point is that even with all of my knowledge, even with all of my understanding, I really forgot what I had, and I had to go back and look at that contract to see what I really had. I don't know that we can design anything that causes people to remember, but I do think we have to move toward more and better disclosure.

MR. KOENIG: Let me respond to the comment briefly. Much of what was said I agree with, particularly the comment that with the nonforfeiture law the way it is, early terminators are taking capital out of the company to the detriment of the long-term persisters. Companies have strived to avoid that, and to get the early values down to the level of the asset share. I think that Barbara's experience with her own personal policy demonstrates the effectiveness with which companies have been able to do that with some of the new designs. I guess that's where I draw the line. If you consciously go after the early terminators, I think that's going one step too far.

FROM THE FLOOR: I thought that the remark about the difference between dividends and nonguaranteed elements being that there's no need for equity in the nonguaranteed elements, was a good place to start the discussion. There is no requirement for equity in nonguaranteed elements, and I thought everybody intended that when they were permitted. One of the reasons that we don't severely restrict dividend formulas, or look very closely at dividend formulas in the regulatory process, is that we feel that there is agreement among actuaries about what equity and dividends mean. Moreover, there is a 50-60-year track record of dividends working fairly well. When we do run into problems, for example with direct recognition, there is some discussion and a position is formulated.

In the case of nonguaranteed elements, we don't have a track record. We don't have actuarial agreement about what proper company behavior is. If we don't have actuarial agreement about proper company behavior in terms of changing credited rates, we really can't discuss what should be illustrated. What does it mean to illustrate the current rate if the company doesn't intend to keep it at that level?

Somewhere in this discussion we need to talk about what the standards are for setting and changing nonguaranteed rates. If we don't agree as actuaries about those standards, or if there's not sufficient regulatory guidance, we cannot talk about what a fair illustration is. In New Jersey I think we do have a standard. We think the standard is that the changes cannot increase the profit margin that was implicit in the contract at issue.

It is a different standard to equity. There is an equity issue present, but our standard is essentially a "no-ripoff" standard, rather than an equity standard. If we were to be clearer about what companies are supposed to do in the future with their non-guaranteed policies, it would be easier for us to decide what a fair illustration method is and what an unfair illustration method is.

MR. NATHAN F. JONES: I am certainly not presenting official views of the New York Department. However I am not aware that anything I have written is in conflict with views held by the Department.

My remarks are limited to life insurance and annuities marketed to individuals by a more or less conventional agency system -- whether "general agent" or "branch manager," "broker" or "full-time, career, captive." Most of what has been written in recent years on this subject appears limited in the same way.

I attended "Illustration Wars" at the 1989 Society of Actuaries Meeting in New York. I have read the *Record* material on "Quality of Life Insurance Sales Illustrations" from the 1990 SOA meeting in San Francisco. Most speakers discussed cost illustrations only.

Essentially all the 1989 and 1990 material is "product-based," with cost illustrations being the major element. "Product-based disclosure" material is easy for regulators to write. The consumerists seem to want more and more of it.

Consider the material (all product-based) required to be distributed to every life insurance applicant in New York: "Buyer's Guide," "preliminary information," "policy summary," and accompanying cost indexes. If a "replacement" or an "SEC-registered" product is involved the applicant receives additional material.

On top of all this comes the sales material the agent really wants the prospect to receive -- including the sales illustrations and the "product enhancements" the insurer's actuary learned about at the last SOA Meeting. There seems to be an unwritten assumption that the prospect has the next three months available to decide which coverage to buy. He or she may even be urged to read the competing policies of two or more insurers.

Of this material probably very little is read. You can understand why I often feel compelled to say to people, "What you really need is a good agent."

I personally have tried to promote need-based disclosure. I hold little hope however. If we did write need-based disclosure material, it would also not be read. Moreover its quality would not touch what that "good agent" -- with knowledge of the applicant's circumstances and ability to conduct an in-depth interview -- could do.

Need-based disclosure would permit separate family protection and investment material. Needs programming for family protection is a skill which has been taught for years. The needs are different now, with two-income families, single-parent families, etc. Covering the needs, to the extent possible, from Social Security, existing insurance, and then from group insurance and other low-cost forms such as savings bank life insurance, is barely touched on in disclosure material I have seen. The effect of future inflation on covering "unmet needs" is seldom discussed.

Choice of insurer is covered extensively in almost all published material. No doubt this coverage will be increased in view of recent media headlines. If there is an agent involved, other than a broker, the insurance will be with the agent's carrier. This makes choice of agent very important.

One thing I think has less importance (than consumerists give it), is unit cost. Rarely is an additional $100/year as important as securing that "good agent."

College education and retirement income are investment needs. It is said that life insurance is not a good short-term investment. Maybe we don't say this enough. Going for that extra one quarter of one percent has been unfortunate for many a policyholder-investor.