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ILLUSTRATIONS

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- The Society of Actuaries Task Force for Research on Life Insurance Sales Illustrations will present the results of its work to date. They will be looking for audience reaction and feedback. There will be ample time for audience questions and opinions.

MS. JUDY FAUCETT: We're going to discuss the preliminary report of the Task Force for Research on Life Insurance Sales Illustrations. I chair that task force. Our preliminary report is hot off the press. Because it has an October 4 date, you can see we were really rushing to get it done in time for this meeting. We are going to give you an overview of it.

To get a sense of where each of you is on the illustration question, I would like to start by taking a straw vote on the questions that we put on our sales illustration survey. The first question is, to what extent do you feel that a problem exists within the industry regarding life insurance illustration practices, in terms of successfully communicating with the potential buyer in a good faith manner? How many of you believe that there is a problem with our illustration practices today? [Virtually everyone raised their hand.] How many of you believe that the problem is such that it cannot be fixed? [A few raised their hand.] How many of you believe that current illustration practices are adequate? [No one raised their hand.] That's good. That means that everybody is interested in what we have to say.

We will spend the first portion of the session describing the work of our task force and the alternatives to current illustration practices that we identified. We are fortunate to have two members of our task force to report on our research. We have John Skar of Fidelity Mutual and John Keller from Northwestern Mutual. The two other members of the task force, Ben Bock and Bruce Booker, were unable to be here.

During the last part of this session, we want your input, comments, and reactions, especially as they relate to the alternatives that we have identified to improve illustrations.

Our task force was formed just under a year ago. We were formed to research life insurance company sales illustration practices from the perspective of the consumer. We operate under the Committee for Research on Social Concerns.

You may ask yourself what the social concerns are with respect to illustrations? First of all, the focus on having the best illustrated performance is a contributing factor to the capital crisis that our industry is facing. As we push down margins to improve the performance of our products, we reduce profits, which reduces our accretions to surplus, and we assume more risk in our asset portfolios and our pricing assumptions.

The concern of the consumer now is whether the company will be there in 30 or 40 years to deliver the illustrated benefits.

The second concern, which is related to the first, is the public credibility of our industry. We've all heard a lot about the junk bond crisis. Is the next crisis going to be junk illustrations? Certainly buyers, agents, third-party advisors, regulators, legislators and even other insurance companies have questioned the credibility and realizability of our illustrations. Industry and professional groups have expressed concern over perceived problems with illustrations. Several have attempted to develop solutions, and others continue to work to improve illustration quality.

Our task force was charged with investigating current illustration practices. We looked at practices in other countries, and we looked at examples that we could find for other financial products. We identified appropriate uses for illustrations. We considered how to make illustrations both more credible and more intelligible to the consumer. We limited most of our research to illustrations provided by life insurance companies. While there are issues regarding how agents modify illustrations out in the field, that is beyond the scope of this task force. Product design, profit standards and pricing assumptions are also beyond our scope.

Now John Keller will begin by describing our research process. John Skar will follow with a discussion of uses of illustrations and examples from other financial products. Finally, John Keller will summarize the alternatives that we identified which might improve illustrations.

MR. JOHN W. KELLER: The first project the task force undertook was to develop a survey to help us determine current illustration practices in the industry. We sent the survey to 87 companies, trying to get a good mix of stocks and mutuals of various sizes. Fifty-six of those 87 companies responded. Of those, 95% said that they did perceive that there is an illustration problem. Sixty-five percent think the problem is serious but fixable.

The number one perceived problem is that buyers simply do not understand the nonguaranteed nature of life insurance illustrations. Also, it is impossible for the average buyer to judge the reasonableness of the assumptions underlying the numbers in the illustration. This leads to the next point, which is that relative values from different companies cannot readily be evaluated. Higher numbers do not always mean better value.

Other perceived problems are that footnotes are not always read by the consumer, that companies have limited control over illustrations that are run by their agents on their personal computers, and that companies have too much discretion in illustrating nonguaranteed elements.

Survey respondents had some suggestions for improving illustrations which included simplifying illustrations, educating the consumer, establishing industry standards for illustrations, and requiring scenario testing with defined assumptions.

Of the 56 companies that responded to the survey, 35 write dividend-paying policies. Of those 35, only one projects mortality improvements in its illustrations. Similarly, only one projects lower expenses and only one projects interest rates. However, 17 of those companies do allow their agents to use alternate interest rates in their illustrations, along with showing the current scale. Fourteen of those 17 allow rates only lower than the current scale. Ten of these companies said that they are seeing increasing complaints from policyowners about dividends.

Forty-nine of the 56 companies surveyed offer universal life products, and all of these allow varying interest rates in their illustrations. However, only four allow interest rates higher than their current rate. Five use mortality assumptions other than current experience, and two use something other than current expense assumptions. Ten of the 49 companies offer persistency bonuses in their universal life policies.

When we inquired about term policies and term look-a-likes, we discovered that there are very few perceived problems. The only two that surfaced were that guaranteed premiums for indeterminate premium-type plans are not always shown on the illustration, and that term plans are sometimes compared to other companies' permanent plans.

In the category of joint-life second-to-die policies, there sometimes is confusion over values before and after the first death and a lack of full disclosure of term elements in some of these contracts.

As part of the survey, we asked companies to send us examples of the illustrations they are currently using. Some of the illustration practices that this brought to light were the inclusion of a separate page in the illustration packet giving the answers to the Chartered Life Underwriter (CLU) Professional Practices Guideline, the provision of a separate page dedicated entirely to the seven-pay test, a requirement that the client or the agent sign a statement saying that they had read and understood the illustration, and the use of a page numbering scheme which prevents an agent from removing selected pages from the illustration packet.

Some other concerns that came to light through the survey were the use of unclear column headings, confusion over the effect of policy loans, and vanishing premium illustrations in which the "guaranteed" column assumed that all premiums were being paid, even though the basic illustration itself assumed the premiums vanished at a certain point in time.

Now John Skar will talk about the uses of illustrations and about illustration practices in other countries and in other financial industries.

MR. JOHN R. SKAR: As we began researching this problem, two questions became central. What criteria should we use to evaluate suggested changes and alternatives? What is the root cause of current problems, and why have previous corrective efforts been so unsuccessful? As research continued, at some point we started to focus on the uses of life policy illustrations. This proved to be a key concept in addressing those two major questions.

First, let's list the major user groups: (1) consumers, (2) agents and brokers, (3) life companies, and (4) third-party analysts. We are all familiar with the first three groups. The third-party analyst is a more recent phenomenon and could be a CPA, consulting actuary, attorney, or other adviser of the consumer. As we all know, life insurance illustrations are very important to all four of these groups.

After thinking about the different ways these groups make use of illustrations, we realized that there really are only two major types of usage that we creatively named "Type A" and "Type B."

Type A explains how contractual mechanisms work. It shows how policy values change over time, under specified premium payment and experience scenarios, or how a particular financial design or concept works such as deferred compensation or vanishing premium. The key thing here is that Type A usage helps the consumer understand what he's buying.

Type B projects future performance. It is used for comparative cost analysis. It evaluates the comparative performance of several policies. The focus is on helping consumers decide which product is the best buy, and on projecting most likely performance estimates.

Having made this categorization, we determined that illustrations work quite well for Type A usage. They don't work well for Type B usage. Why is that?

Life products are very complex financial instruments whose ultimate cost and performance depend on hundreds of factors. If you're going to do a prospective, comparative cost analysis on two or more contracts, using sound actuarial principles, you will discover that it just can't be done with sales illustrations. They are structurally incapable of that, even if done with integrity.

Second, one of the critical items needed for a meaningful Type B analysis is a measure of relative risk. Let's assume that one illustration requires 15% lower premiums, but has a 60% greater risk of not achieving projected values. If this relative risk is not disclosed, then a comparative cost evaluation is meaningless and probably misleading.

Now for the bad news. Type B usage is in great demand! All of the user groups we mentioned are very interested in Type B analysis. That is probably why regulations are designed to keep the playing field relatively level -- to facilitate Type B comparisons. The problem is, it just has not worked. No amount of regulation or ethical behavior or integrity has overcome the basic fact that illustrations are structurally incapable of handling Type B questions.

We tend to take Type B usage for granted, and need to remember that the history of sales illustration practices in North America is somewhat unique. Thirty years ago, economic conditions were relatively stable, rates and dividends changed gradually, product features were relatively simple, and relative risk among products was similar. You could use ledger illustrations for Type B purposes, and not be too wrong. With today's market conditions, it just isn't practical to use illustrations as a comparative performance measure.

To help put things in perspective, we studied illustration usage in other countries and in other financial industries. This provided a perspective on how we are doing and where we may be going.

In the U.K., there is heavy regulation of illustrations, and standardized assumptions. There is a strong belief and understanding by regulators that illustrations have a limited scope and should not be used for comparative performance measurement. In Australia, there is less standardization than in the U.K., but there is recognition that illustrations should not be used for comparative performance or cost evaluation.

Just before this meeting, we received a very helpful letter from Mike Freeman of the Tillinghast office in Sydney. I'd like to quote from the letter, as it contains information not found in the draft report:

> Under the Australian approach, illustrations must be based on specified earnings yields but, unlike the position in the U.K., illustrations take account of the actual charges levied by the office on the policyholder. In this way, illustrations can potentially be used for comparative purposes, although as has already been described, the achievement of this objective is largely illusory. This contrasts with the U.K. regulations under which all illustrations for a particular product type (for a particular age, term and premium) will be the same regardless of individual companies charging or expense structures. There is a clear threat that new regulations will be amended towards the U.K. position, if it is perceived that the new guidelines in Australia do not work.
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> In summary, regulations in the U.K. and Australia have, to date, taken different approaches to the regulation of policy illustrations. Nevertheless, there is common ground that illustrations have in the past failed to provide prospective policyholders with useful information. Regulation of illustrations in the U.K. emphasizes their suitability for Type A usage only. In Australia, illustrations continue to aim to provide a valid comparison between companies. Nevertheless, it is clear that the situation remains under continuing review, with any further changes likely to produce more rather than less standardization.

Finally, if we turn our attention to the U.S. securities industry, we note that they do not allow anything like our life insurance illustrations to be used for comparative purposes. You can show retrospective performance, but any prospective comparative illustrations must use identical investment assumptions.

Now John Keller will summarize the rest of the report.

MR. KELLER: In the report, the task force developed a number of suggested alternatives to current illustrations. The first grouping of suggestions deals with reducing or limiting the numbers used in illustrations. This might be done by substituting graphs for the long lists of numbers, or by limiting the numbers to year-by-year listings for only the first 20 policy years and then using quinquennial durations thereafter, by rounding numbers to the nearest hundred or thousand dollars. Our goals were to make the illustrations more readable, especially to those who might be intimidated by so many numbers, and to remove the false sense of accuracy that large numbers calculated to the nearest dollar seem to convey.

The next group of suggestions deals with more stringent requirements for the nonguaranteed elements shown in illustrations. These include a better definition of current experience or current dividend scale, establishing the concept of an illustration actuary, inclusion of historical data, disclosure of underlying assumptions and current experience, and disclosure of any unusual features included in the policy being illustrated such as the use of persistency bonuses, lapse supported design or the use of terminal dividends.

Another area where we felt further study is warranted concerns the consistency of illustrations from company to company. It may be desirable to strive for standard formats or standard footnotes. Perhaps certain portions of the illustration should be required to be in boldface type. There may also be some benefit to be gained by requiring standard assumptions or a range approach with specified scenarios.

Finally, the task force pinpointed some strategic or educational efforts that might be pursued. These include: changing the use of the illustration in the sales process; developing a consumer brochure to educate the consumer on what an illustration is and what it isn't; establishing an industrywide consumer hotline; requiring the consumer's signature; using the illustration as a sort of road map which would be updated periodically so that the policyowner has some idea as to how things are actually going compared to the way they were illustrated when he bought the policy; and finally, requiring more intensive agent education so that agents thoroughly understand what an illustration is and what it isn't. Now I will turn it back to Judy for a summary.

MS. FAUCETT: The shortest portion of our report is the "Next Step" section. Our group does intend to produce a final report that will include specific recommendations on each of the alternatives or changes to illustration practices that have been identified. But before we do that, we want some input from the membership and other interested parties. We want to know what alternatives are doable, which ones really help the consumer, which ones will add to the integrity of our illustrations, which ones can simplify yet maintain the integrity of our illustrations, and what responsibility we have as professionals to improve the credibility and the integrity of illustrations. That is why we are having open forums at this meeting and at the Canadian Institute of Actuaries meeting in November. We have placed notices with the recently mailed *Actuary* about the availability of this report. We want as much input as possible from everyone as to what direction you think we should be taking and which items really are actionable. We would now like to hear your comments and your questions.

MR. WALTER N. MILLER: Many of the questions here are definitional. It's possible for a lot of the people or the companies they represent to say things like, "Illustrations for my policy represent a rational buildup of policyowner funds linked to established and documentable patterns of persistency. Your policy is lapse-supported. It ought to be banned and thrown out." But the meaning of "lapse-supported" is not unique in this context.

There is an increasing degree of interest in this area in the actuarial world. A lot of people tend to forget, however, that for perhaps 15 years, actuaries may have been the only people who were really trying, and in some cases with some success, to make some progress in dealing with these very tough issues. We now have the annual statement interrogatories on dividends and nonguaranteed elements that are strictly the output of the actuarial community. They are certainly not the ultimate answer to the question, but I would suggest that they provide a pretty good base, and I hope they're not thrown out if there is a rush to build a new structure.

When those interrogatories first came out, a lot of people said, "This is totally useless because if a company ever gets into tough times when it's going to have to reduce dividends or credited interest rates, they'll never admit it." Yet if you look at the answers to key questions like, "Are any facets of your illustrations or your scale reflective of experience that is different from current experience?" or "Can you continue the scale if current conditions continue?" you will see a lot of less-than-clean answers, meaning candid answers. And guess what? The companies offering those candid, less-than-clean answers have not been forced out of business in the market-place as a result.

The profession really needs to mount a concerted effort now, and this may be a good beginning. If you leave a vacuum that you can fill but don't, it will get filled by somebody else, probably to your detriment. If the actuarial profession cannot move on and build on the base that they have already succeeded in constructing, the regulators are going to be right in there and who knows what will happen.

One final word of urging. It is very easy, looking around at many current illustration practices that are documented in this good report and elsewhere, to say, "Wow, that's awful. That stinks. We have to ban that. We can't let people do that ever again." I would urge very strongly that in terms of a basic concept to guide us for the long term, it should be disclosure rather than prohibition. Disclosure carries a heavy educational burden, but I think the outcome of a lot of prohibition alternatives can be far worse. One current example of that is a proposal that seems to have some regulatory force behind it. It came up in the committee that is revising the standard nonforfeiture law. The proposal was with respect to nonguaranteed persistency bonuses and it was very simple. It said that if a company did not guarantee a persistency bonus, it could not illustrate it. Proposals like that won't go away. They are not necessarily the best answer to problematical situations like that. There ought to be a disclosure approach to that and similar situations that is much more workable.

MR. PAUL A. HEKMAN: I think that we must not focus exclusively on current values here. I would like to see an environment in which the guaranteed values could be more meaningful as well. Guaranteed cost of insurance charges are frequently extremely high, as high as companies feel they can get away with. Guaranteed interest rates frequently are very, very low. The reason is that if you try to make those guarantees a little bit more meaningful, you run afoul of the valuation process because this raises the reserves sky high. The regulators need to recognize that this restrictive reserve system that we use in the U.S. is part of the driving force behind the problems that we have with the illustration process. If we could have a more intelligent valuation routine, we could probably make the guarantees more effective and more efficient as well.

MR. ALISTAIR NEILL*: I thought I might update you on the current U.K. position. Last week we received a consultative document which I tried to read on the flight over to Toronto on Saturday. They are now thinking of going to company-specific expense charges in illustrations, but still keeping the same investment assumptions for all offices. The really horrid thing is that they want to demonstrate how much money is lost to the policyholder for expenses. They will make you say something like, "If there had been no expenses in this office, the maturity value of your policy is estimated at 20,000 pounds. You are only going to get 15,000 pounds after expenses, so you've lost a quarter of your money."

MR. YUICHI KATOH: In Japan, the Planning Committee of the Life Insurance Association on the Method of Dividend Illustration in Sales Documents has issued a report. Although the details are not final yet, it is believed that the measures stated in this report will become effective in July 1992.

A summary of the report follows. Below is a brief explanation of some terms which appear in the report. *Ordinary dividend* is interest dividend + mortality dividend + expense dividend, which is usually distributed after the second policy year. *Special dividend* is λ-dividend and μ-dividend. The *λ-dividend* is a special dividend which is distributed together with ordinary dividend after the seventh policy year. The *μ-dividend* is a special dividend which is distributed after the 10th policy year on maturity or termination of life policies.

METHOD OF DIVIDEND ILLUSTRATION IN SALES DOCUMENTS IN JAPAN

In current sales documents, dividend illustrations are based on the dividend scale which is determined at the time of the nearest fiscal year end valuation. This practice may lead to the misunderstanding that the current dividend scale will remain unchanged in future years. Due to the long-term nature of the insurance contract, a small change in the dividend scale may produce results that differ significantly from sales illustrations. To alleviate this practice, the following measures will be put into practice:

1. **A statement as to the effect of a variation in the interest dividend.**
   In order to avoid the misconception that the dividend shown in the sales document is guaranteed, and to emphasize that the dividend is variable, the sales document will disclose the effect of a change in the dividend scale.

   a. The following statement shall be shown:

      If there is a 0.1% decrease in the interest dividend plus λ-dividend scale, resulting in a 0.1% decrease in the dividend accumulation rate, the projected dividend will decrease by approximately ¥xxx. A variation of more than 0.1% is possible.

* Mr. Neill, not a member of the Society, is General Manager of the Scottish Widows' Fund in Edinburgh, Scotland.

b. Due to the stable nature and predictability of mortality dividends and expense dividends, a statement as to the effect of fluctuations in these dividends is not necessary.

2. **μ-dividend**
The μ-dividend is essentially different from the ordinary dividend. The μ-dividend exists to return gains that have not been returned by ordinary dividends to policies that have continued for an extended period of time. The current practice of showing the sum of the ordinary dividend and the μ-dividend in sales material will, therefore, be discontinued, with the ordinary dividend and the μ-dividend being shown separately.

3. **Enhanced use of caveats in dividend illustrations**
The explanation of dividend illustrations will be enlarged to include the following:

   a. Structure of dividends -- the three sources from which gains may arise, as well as special dividend, accumulated interest dividend, and so on – should be explained.

   b. Increased attention should be placed on the variability of dividends.

   c. Dividend illustrations should be based on the assumption that the current dividend scale will remain in effect until maturity.

   d. The effect of a 0.1% change in the interest dividend scale should be shown.

4. **Time of enforcement**
These changes should be placed in effect on or after the next date industry sales documents are scheduled to be updated, or, if later, at such time that each company is prepared to administer the revised sales documents.

MR. BRUCE E. NICKERSON: One of the concerns that is expressed in some areas has to do with illustrations that are not produced directly by the insurance company itself. Certain people say that this is an area of very real potential abuse and perhaps should be banned or severely restricted. I would like to suggest a couple of things. First, I have been engaged on various occasions to produce illustration programs that illustrate valid contractual uses of the policy that the insurance company was either unable or unwilling to produce. Now, to say that a marketing organization cannot produce a Type A illustration to illustrate something that is perfectly valid and legitimate, according to the terms of a contract, because the insurance company hasn't gotten around to producing that illustration, would be a great disservice to the industry. That needs to be provided for.

Another problem area that I have encountered is company-produced illustrations that are not consistent with the terms of the company's own contract. I would suggest that this be put at the very top of the list of problems. I have had discussions on more than one occasion with company actuaries and said, "Your contract says this.

The numbers don't balance out." It turns out that the illustration program doesn't quite track what the contract terms are.

A third problem is of great concern to me, in terms of my own personal ethics rather than any business concern. A few years ago, an awful lot of universal life policies were sold using, in effect, level premium illustrations – your policy will go for all of life or whatever – with companies using 10% or 11% interest rates, which is what the interest rate environment was then. The concern that I have, which may soon give much of the industry a very black eye, is that while people have received, as required by law, the annual updated policy values, they have not been shown that in all too many cases, their policy is going to end up having no cash value, perhaps when they reach 74 or 75. When we combine that with what the current federal law states you can do with a life insurance policy, you will then find yourself as a customer who has a policy with no value, where you cannot legally pay more than the annual renewable term (ART) premium (and the ART premiums in many of those policies are high, offset by what was supposed to be a good interest credit). We may have created an illusion that will crash down on many people that they had whole life coverage, and now they find themselves with what is truly annual renewable term to insolvency.

MR. A. MICHEAL MCMAHON: I think this is a great step for us to go forward with. One of my concerns would deal with looking at lots of numbers. We can talk about limiting the amount of numbers that we look at, such as 20 years and quinquennial, Type A and Type B. The Chartered Life Underwriters organization has tried to address some of these issues with its own guidelines. They look at it from their perspective. A logical next step for us would be to have some focus groups or consumer groups -- not consumer groups in the political sense, but some true consumers groups -- get together, look at this problem and give us some input as to what would be meaningful to them. A brochure is fine, but would they read it or would it end up being treated like the current brochures that we hand out when we issue a policy.

MS. FAUCETT: You raise a very good point. We contacted a number of regulators during the course of our research. The California department was gracious enough to pull 80 complaints that they had received from consumers in the last year, a random 80 complaints. Out of those 80 complaints on life insurance, they determined that 35 of them were illustration-related. Fifty-five percent were for reasons you would have expected; that is, the premium didn't vanish when it was supposed to, or the dividends that were paid weren't as high as what was illustrated. The other 45% believed that they had bought an annuity product and didn't even know that they had life insurance! Maybe there is something that we're not communicating to buyers out there. We may think that our illustrations are straightforward, but somehow the people who aren't actuaries or agents or who just don't understand insurance, are missing the point. Admittedly, not everybody complains, but the number was a lot higher than we had expected, and it was a very different type of complaint than we had expected.

MR. JAMES F. REISKYTL: I'm very pleased that Daphne Bartlett, our President, established this group because I have had a long-standing interest in the subject, and I know she has too. I'm very pleased to see the initial report. It's a difficult subject, strangely difficult. If there is any area where actuaries should provide some leadership, it should be in illustrations. I understand that some companies don't listen to the actuary when establishing the final illustrations. I guess Armand de Palo keeps saying that we have to have illustration actuaries. I am appalled at the idea that we will have to have an actuary in every area with a label on to get actuarial work done, but apparently we move that way sometimes.

Walt Miller and I have been involved in this area for some time. We're now working with the CLUs to try to improve their document. They look to actuaries for guidance and in some ways, fortunately or unfortunately, I think we have to look to agents to try to put some meat to this whole subject.

I have a couple of specific comments about the report. I think Type A usage is very easy for us to dismiss because actuaries understand it. I think the points you just made, Judy, are very accurate. I question whether people in the marketplace understand how short-pay policies, quick-pay policies, minimum premiums and all the rest work. It seems to me that we ought to put these concepts into our illustrations. If the contracts will not provide for coverage for life, for example, although they put the name whole life or universal life on them, some disclosure should be made. I would recommend to you and your team that you consider expanding that section to the obvious, but perhaps the world needs to understand the obvious. I know at the Northwestern Mutual, we have had increasing complaints about short-pay and quick-pay policies, because people just don't understand how they work. In some cases, I think our agents have done a good job of explaining it; in other cases I'm not so sure. This gets back to whether a consumer understands. Whatever you told them, if they thought they bought an annuity instead of life insurance, that's getting pretty basic.

The second suggestion is in the area of using illustrations to compare costs. You did a survey but you didn't do a survey of the consumer. You may want to do a survey to find out if consumers want to use illustrations to compare costs. We might start with that assumption. I happen to believe that has merit, but I think we ought to find out if in fact they want to use it for that purpose. If they don't use illustrations for that purpose, how will they compare companies? You might consider a survey in that direction, along with asking the companies what they think of the illustrations.

The third suggestion is to reinforce the comments regarding consistency of current experience, defining what it is, and disclosure. Again, I agree with Walt that we shouldn't ban anything. Some of us worked on the dividend illustration thing for maybe eight years, and the common message was clearly that, "Everything is fine. Just disclose it." I suggested in a recent phone call with the CLU group that if a company will not disclose the underlying experience for the dividend scale, the agent may wish to cease selling for that company. That may seem like a very strong action to take. I'm not suggesting that they would have to say what the mortality rates are, or the interest rates and so on. But you would have to disclose what they were based on. For example, your mortality is based on the last five years experience of the company. Or it is based on some projected improvement, based on improved underwriting practices, or whatever. The actuary must have some idea of what the basis is.

I would hope that the final report will have more than just a paragraph saying that it is very difficult to deal with current experience, that current experience is being undermined, understated, and misunderstood in the marketplace. I would encourage your group to spend a lot of effort to try to improve the understanding of what current experience is and to establish definitions for it. And I would go another step. One of the problems the CLUs have is if they say, "Well, this isn't our current experience, but we've assumed 5% improvement," they have no idea what that means. They've asked Walt and me and some others to try to help them with this. It seems to me, at least in my initial thinking, that if you were not illustrating your current experience, you would have to disclose, in some numerical way, what the impact of that decision was. So if you disclosed that you have increased your dividend interest rate by 10 basis points a year, you would disclose that this has the following impact on the cash available at 65, or whatever it may be. So I'm trying to be constructive.

I think the two areas with a lot more to be done are how you define current experience, and how you disclose what the differences in current experience mean. We want to remain an actuarial profession, but if we cannot deal with illustrations, we will clearly have limited our ability to be effective spokespeople for the industry.

MS. FAUCETT: I saw a case recently where we "reverse engineered" the values that were 25 years out. We knew what the interest rates were, and we knew what the expenses were in the contract. To get from the set of values in one year to the next, we found that we had to use mortality rates for a female nonsmoker. We are trying to work with that company to understand how its experience supports an illustration that favorable. And whatever its underwriting rules are, we're going to try to use that in all products we develop going forward because it's so good.

MR. MICHAEL J. ROSCOE: We're showing projections with a premium you need to pay at today's level of interest, but customers are not paying attention to the annual statement that's coming their way every year that shows what's happening. They're not going to pay attention until they get that lapse notice saying they have to come up with so much money in the next 30 or 60 days or whatever. I believe that this is a very significant problem, and it's getting worse. I haven't done any actual analysis, but I believe that in the last 12 months, the investment returns received by insurance companies have probably dropped at least 100 basis points, whereas the median interest rate that's currently available and shown on illustrations has probably dropped by less than 50 basis points in the same period of time. That leads me to believe that the projections being shown today are not at all supported. It goes in line with some of those candid responses to the interrogatories on the nonguaranteed elements that companies cannot keep up the current projections based on their current level of interest. The policyholders have no idea that this is what's going on. They just see that this is the premium they have to pay. They are looking for a low premium for permanent insurance, and there are going to be some rude awakenings for the industry in the not-too-distant future.

MR. ROBERT H. DREYER: I have two comments to make. First, we do permit projection of interest rates higher than our current rate. Our current interest rate has never been higher than 8%, but we permit these projections as a leveling influence so that if an agent runs into a proposal at 9% or 10%, he can run his proposal at 10% and say, "If you believe that they're going to pay 10%, fine. But if they're going to come down to our interest rate, we've got the better product." We teach that approach through our sales support staff. But that's the only way that they use it. The other comment relates to what Walt said and Jim seconded, about permitting a wide range of things in proposals but requiring disclosure. I'd like to take it one step further and suggest that if you believe in something enough to put it into a proposal, then your appointed actuary had better believe it enough to put it into his valuation and cash flow projections.

MR. CHARLES C. MCLEOD: I support the task force's efforts in this area, because I frequently have trouble understanding the illustrations of other companies' products myself. If I as an actuary have trouble understanding them, the customer really has no idea of what he or she is actually buying or the risks associated with the product, in many cases. I think your goals should be, if you want to see results in this area, to develop a set of guidelines or regulations for the regulators to adopt in this area. I say this with hesitation because, as a general rule, I don't like seeing regulators getting involved. I think the industry or the profession should try to sort this out itself. But I think there are so many companies hiding behind misleading illustrations that the only way this can get done is if the regulators come up with some guidelines. And I think the actuarial profession is in the best position to suggest some appropriate guidelines to them.

MR. BRIAN KAVANAGH*: I would like to point out the significance of regulation in this area. When there are regulations in place, you tend to go to the strictest interpretation. So regulation is a force that is currently pushing people into full disclosure. For example, in New Jersey, they will not allow persistency bonuses. So, there's a tendency not to include those kinds of elements in product development. Recently, in New York, they've come up with regulations concerning minimum cost of insurance. For example, that 3% would not hold up. I believe the best long-term projection we could make is 30% of Commissioners Standard Ordinary (CSO). Anyway, to that extent, I think it's very important that any regulations or suggestions that we come up with are consistent with what the states want, because in the end, they will do the interpreting, and they will require what they want. And if you try to get approval of illustration software, which is a requirement of many states, you're going to find you can't get approval unless you meet certain standards. So we can't say this is the way things should be in isolation, because there's a large group of people out there who already, on a state-by-state basis and not always consistently, are placing requirements on us in certain situations.

My last comment is that mutual companies would seem to have an advantage over stock companies in that they can describe their dividend structure as always varying, but they do not have to say how the dividends were arrived at. Stock companies, in contrast, have to say what the interest rate is and because it is part of disclosure, you can back into what the costs of insurance are. To that extent, I believe stock companies are not on a level playing field. The mutual companies have the advantage. For example, in New York, the New York Insurance Department regulates that you cannot assume less than 30%. In New York, we're definitely not playing on a level playing field.

* *Mr. Kavanagh, not a member of the Society, is a Consulting Actuary in Chicago, Illinois.*

I would like to finish up by repeating that we are not in a vacuum. There are regulators out there. There are regulations. Many states now have regulations that say your illustrations cannot be misleading. They have to be fair, and we have an obligation to make sure that they are. In addition, however, I believe that there is major conflict between stock companies and mutual companies, especially in the area of regulating the disclosure of the minimum cost of insurance.

MR. KLAUS O. SHIGLEY: I would like to comment about interest rates. I think one of the pressures on illustrations is the fact that we price products in one of two ways: using either new money rates or portfolio rates. As long as we continue to accept either of those practices, there will always be pressure on illustrations to do more and more of what they are not intended to do. One way to get around this is to mandate disclosure on the basis of a new money interest rate, for example, regardless of what was actually used to credit interest rates. This would force disclosure of a certain interest rate defined to be net of investment expenses only, for example, and the use of that as a common yardstick for showing illustrations. This would solve a lot of the problems we have. If we keep trying to have the best of both worlds, higher book and market values and higher new money rates, we will find ourselves in an endless cycle.

The other idea I would like to offer is that leveraging turnover rates is a major problem, for example, the lapse supported strategies. Think what would happen if we were forced to disclose negative statutory returns based on the asset share, say 10 or 15 or 20 years down the road, or if we were forced to disclose whenever we had negative book profits some period of time down the road. We could have negative book profits, but we would have to disclose it. This would get at this problem that you can leverage these illustrations to do miracles which they are not going to perform.

MR. RODNEY C. WILTON: I'm not surprised that some people have seen life insurance illustrations that they thought were for annuities, because lately I've been seeing illustrations that use life insurance policies to accumulate money until retirement age and then use wash loans as a nontaxable form of retirement income until an advanced old age when presumably the person dies. The illustrations do this because of the assumption that no tax will ever be paid on the buildup or the pay-out, so it shows a higher retirement income than an annuity which has to deal with taxation of the income. The assumption that the current tax laws will remain in force for 60 or 70 years seems to me, even less likely than that the current interest rates will be met.

MR. STEPHEN N. PATZMAN: One of you mentioned something in your comments about integrity and professionalism. This all seems to be revolving around the actual illustration, not the actuary who is producing it. I think there might be more emphasis put on the actuary. Whether it's the illustration actuary or the valuation actuary who signs the statement, we may some day be requiring actuaries to go to courses on ethics. This might bring some real force to this project, because it's all going to come back to us as actuaries if in five or ten years or even a couple of years legislation comes down upon us. That's going to reflect back upon us as professionals. I think we need to do something in that area.

MR. I. EDWARD PRICE: We've heard lots of people talk about a variety of what I'll loosely call adjustments that we might make. Walt talked a lot about disclosure. I think Jim talked about disclosing what the difference in illustrations might be between projected mortality (if you're using it) and current mortality. We had talked about disclosing things related to asset share results or book profits. Those are things that are natural for us to understand and be concerned about. But I think the point that has already been made must be kept very high on our list: we need illustrations that consumers will understand. I don't really think they're going to understand an awful lot of the kinds of things that we have been suggesting. So I urge you not to lose sight of the objective, which is to produce an illustration that a customer three, four, five, or ten years down the road, can go back to and understand.

MS. FAUCETT: We were sent a number of illustrations. One company gave us the full array of all of the options that were available, in its illustration package. It was a 21- or a 23-page package, explaining the company and its product. We came to the conclusion that if you disclose absolutely everything about your product, you can be sure that no one will look at the illustration. People will just assume that it has to be true because you are giving them so much information. It is true that one of the things we have to remember is not to overwhelm people with too much information, and to put our information in a format that people can understand.

MR. NICKERSON: A thought has just come to me listening to this discussion. Part of it was what you were just addressing -- the problem of information overload in the normal context. The other part is addressing the concern that if we try to solve this through increasing regulation, we are going to get ourselves locked into inflexibilities, which lead to problems dealing with future situations that we cannot anticipate now.

In one sense, any sales illustration is a form of an actuarial report to a potential reader, whether it be a consumer or someone else. Now we have an increasing body of actuarial standards with regard to actuarial reports. I would not suggest that compliance with those standards of disclosure, etc. be part of the normal illustration. But perhaps we might, as a profession, want to consider requiring an appropriate actuary in any company to prepare a report subject to our normal actuarial standards process to be available on request. That might itself, through the potential investigations by various types of organizations ranging from regulators to *Consumer Reports* or whomever you have, go a long way toward enforcing the type of self discipline that we are really looking for here.

MR. THOMAS L. BAKOS: Of the two uses of illustrations, one was to illustrate how a product operates, called Type A use. Type B use was to somehow demonstrate the cost of the product that was being sold. It seems to me that most of the problems with illustrations come from the use of illustrations in that Type B situation. My personal view is that the only legitimate use of an illustration should be to indicate how the product or how the concept is supposed to work. If that's all the illustration was used for, then the other problems wouldn't exist (although you can't really be certain that you'd be successful doing that, if you had a lot of policyholders who thought they were buying annuities). We need to work first on making sure that the illustration correctly demonstrates how a product works. Most illustrations do that pretty well. Then, we must recognize the dangers of using an illustration to illustrate costs. Anybody who believed an illustration that purported to demonstrate cost would be a foolish person.

MR. SKAR: To follow up on that point, there are many types of disclosures. But for a very simple type of disclosure, there are three or four examples on Page 34 that get right at that point. I don't think it's realistic to expect consumers to understand all the disclosures that we currently have, let alone some of the more complicated ones that have been talked about. But I think you might be able to get consumers to understand that it's at their own risk if they try to use illustrations for Type B purposes. It would be roughly like the Surgeon General's warning on a pack of cigarettes. That is a very simple disclosure that I personally think would go a long way in the right direction.

MR. REISKYTL: The idea that the numbers measure cost in any illustration is clearly put to rest by a disclaimer which says that these are not guarantees, and that there is no intent that they ever would measure projected costs in the future. I would downplay that in a report, but that is my perspective. From a similar perspective, I believe illustrations are useful to compare companies, or perhaps they could be useful to compare companies. If you read the Jensen paper in *TSA* XXX, page 447, you get into projecting dividends and risk factors. That is interesting, but in my opinion irrelevant, because I don't know who would decide the amount of risk factor in anyone's illustration. Perhaps the four of you would be the board to decide the risk factor. If you want to take this on, bless you. I don't know how anyone could ever imagine doing that.

On the other hand, although I said earlier that I would like to know what the consumer wants, I think people would like to know why they should buy from one company and not another. Clearly, people make decisions based on illustrations. I don't think they make decisions based on thinking that what they show is going to be the actual cost, but they might think that they are useful for comparing value between companies. I would surely like for that not to get lost. I think illustrations are more useful than just to show how a policy may work, how long you may have to pay premiums or whatever it may be. But if we are not going to compare companies based on illustrations for relative values between companies, not projecting cost but relative values, then you have to decide what mechanism can be used to compare costs to make a buying decision. To simply say that all policies are created equal and will provide equal value will be more misleading than current illustrations.

MR. MILLER: I have a postscript on one of the themes that's been struck here. About three-and-a-half years ago now, Joe Belth devoted one of his monthly newsletters to the topic of what's going to happen when the economy will not permit companies to perform in the way that they used to be illustrating. Joe devoted his entire issue to this subject, with the title, "The Forthcoming Crisis of Unfulfilled Policyowner Expectations." I think it's fair to say that collectively we in our companies are in the middle of that. The educational task is huge, and it's not just with the customers; it's with our agents also. I would say to all of you that if you think that you don't have any customers or any agents who fail to understand what a nonguaranteed illustration really means, you're kidding yourself. And if you don't think that you have customers out there (which means agents also) who believe that a vanishing premium illustration means that the policy becomes paid up in contractual terms, you're kidding yourself. We are going to learn by doing as we all go through this period of more and more unfulfilled policyowner expectations.

MS. FAUCETT: Most of the comments that we've had have been from U.S. perspectives. Certainly we are all familiar with the perceived problems of competitiveness of U.S. products. I was wondering if we could get some comments from the Canadian side as to how you perceive the problem, and whether it is as significant in Canada as it is in the U.S.

MR. NEVILLE S. HENDERSON: We haven't done any recent surveys of illustrations in use in Canada. There is no question, however, that we see many sales illustrations, and get the opportunity to look at what other companies have done. There's no question in my mind that the situation is getting dire for us. When I take a look at what some companies have done to illustrate the values of the policies well down the road, often using increasing interest rates even though the illustration seems to imply a level interest rate throughout, I find that disconcerting. Reverse engineering, which is working backwards to understand what went into the illustration and discovering that excessive lapse rates were used to inflate the illustration values well into the future, is also disconcerting. I suppose it's even more disconcerting that some of those companies seem to use those lapse assumptions in pricing their products, which makes one wonder about their profitability in the long run.

The biggest concern I have about the Canadian situation, however, is my expectation that we're going to have new competitors in our business within the next five years. We always use a push method of marketing through our distribution systems. The new competitors are likely to use a pull form of marketing. My biggest concern in that type of marketing is that the objective is to cast doubt on your competitors or how the competitors sell their products, and make it look like the competitors' illustrations might be unachievable. I strongly suspect that we're going to see some of those new competitors make a strong attack on what the Canadian insurance companies have been doing in their illustrations and bring our integrity into question. They are likely to use that strongly to their own advantage in getting insurance business in Canada.

With respect to a number of the comments that were made, I agree that the profession has a very strong role to play in this, and I think that we have to be accountable, to some extent, for coming up with reasonable projections. I have a great deal of concern about how the agent might use those and how we would ever control what the agent does. Somehow I think we need to tie in the actuarial profession with various agents' professional organizations, so that if the agent does in fact bastardize an illustration and make it completely unrealistic, he is liable too for discipline.

Anyway, the situation in Canada is very similar to the States, with a lot of projections done along the same lines. Vanishing premiums are fairly heavily used. We see them frequently. We currently have Section 148 in the Income Tax Act that allows long-range projections, taking advantage of tax deferral on interest buildup. A big question, as Rodney pointed out, is whether that tax law will remain in place several decades from now. In fact, it is a big question as to whether it will remain in place by the end of this year. There are some very strong issues here, and I think the profession has to address them. I sincerely hope that we take a look at the agent and his role in this entire process.

MR. ISADORE JERMYN: The committee has done an impressive job. The draft reflects a high ethical standard that is uplifting and refreshing -- comments that don't apply to all actuarial sessions. I found Type A versus Type B to be a very useful distinction, and I hope that as you go through with your work, Type A prevails in the end. In order to do that, though, you have a difficult problem, which is what Jim Reiskytl was talking about. That is how a consumer can differentiate between different products and different companies. There was a section in your report on some of the other ways that you can do that. Maybe you could expand on the work in that area to try to see whether there is really a middle ground. Perhaps we can downplay the illustration from being what it is now for many people, the primary tool for differentiating, to not being a tool at all, or no more than a secondary tool.

MS. FAUCETT: Now I would like to ask John Skar and then John Keller to give their reactions to the comments they've heard.

MR. SKAR: I believe that illustrations are being used as a quick and dirty mechanism for making Type B evaluations. As actuaries, we know this is improper if we are intellectually honest with ourselves. Our products are very complex, at least as complex as those in the securities industry. It is likely that the increasing demands for disclosure and information are moving us toward a prospectus as the primary evaluation tool. It's not a sales illustration at all, but a prospectus. Perhaps this prospectus will contain an actuarial report.

Someone commented that agents and consumers really don't understand the basics of what they are buying and selling. In other words, Type A usage gets short shrift. One of the reasons for this is that they focus on Type B uses for illustrations rather than Type A. We need to help put more emphasis on Type A usage.

Another issue mentioned was actuarial integrity or ethics. It might help to use an analogy. Trying to assess the relative aggressiveness or integrity of illustrations is similar to determining whether people on a highway are driving at a reasonable and proper speed. Driving between 50 and 70 miles per hour may be reasonable and proper, but there is still quite a difference in speed. They will arrive at their destination at very different times. Applying this example to illustrations, we can construct them with integrity and still not have something meaningful for Type B purposes, because there will always be too much variation in what is reasonable and proper.

Along the same lines, many consumers believe that while illustrations may not be perfect predictors, they are the best available indicator of performance. The consumer tends to say, "Well, I think all these illustrations may overstate reality, but the rank order must be about right." At the spring meeting this year in New York, Roger Heath gave an excellent presentation which exposed the fallacy of this assumption. He used the results of the Tillinghast TULAS study to do a simple correlation between product value and illustrated performance. What he found was that there was almost no correlation. If anything, the correlation was slightly negative. This suggests that the "best available indicator" theory is a myth. I think we ought to say that it's a myth.

MR. KELLER: I'll respond briefly to the suggestion that we use focus groups to get the consumer point of view. We did consider that early on in our work and rejected it for a couple of reasons. One was the time constraints we were under and the cost of doing focus groups. But probably the most important reason is that if you get 15 people in a room who are recent purchasers of life insurance and then spend an hour or two dissecting the sales process and the use of their illustrations in that sales process, you're likely to have 13 people coming out slightly or greatly disillusioned over what they just did. We found that our field force and our marketing department didn't like that idea at all. So if somebody could think of a way to get to the consumer without causing real problems among recent buyers, who are our most fragile customers, we would like to hear it.

MS. FAUCETT: In line with John's comments, we were told by one group that actually runs focus groups that if you got a group of recent purchasers of insurance in a room, you might get responses of what they think they did or what they think they should have done, as opposed to what they actually did. They suggested that the only way you could actually tell how a consumer was being influenced by the illustration was to sit through an actual presentation between the agent and the consumer and say things like, "Okay, now you just listened to what the agent said and you looked at the illustration. What are you thinking about now? How is the illustration impacting your purchase?" It was hard to imagine that we could find many agents who would be willing to let us interact with their clients in that way. People who actually make money out of focus groups were discouraging us, telling us that we were not going to get quality results from that process. But if some of you have experience with other groups that have taken on something like this, we'd certainly be interested in hearing about it.

MR. REISKYTL: The intent was to ask the consumer what they expected. I was not trying to find out what they knew because that is something else. I want to know if we are designing something for them. It might be interesting to know what did they expect this thing to do and hopefully we'd eliminate that tension. It doesn't have to be a focus group. We could send out a questionnaire, just as you send out a questionnaire to policyowners and ask them what they expect from illustrations they receive.