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LIFE INSURANCE SALES ILLUSTRATIONS

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The panel will present the findings of the Task Force for Research on Life Insurance Sales Illustrations, and the present direction of regulation in this area in the U.S. Task Force recommendations reflect input received from:

- Regulators
- Individual life insurance companies
- *Actuaries and other insurance professionals responding to the* preliminary report.

MR. BENJAMIN J. BOCK: I work at Transamerica Occidental, overseeing product implementation efforts from the actuarial point of view. Judy Faucett and I will be talking about the subject of "Life Insurance Sales Illustrations," also known as the illustration wars, a topic of growing interest over the last few years. It was on the agenda of Society of Actuaries Meetings in 1989, 1990, and 1991. Judy and I are two of the members of a Society of Actuaries Task Force that was appointed by Daphne Bartlett in 1990 to look at the illustration problem. The other members of our Task Force were Bruce Booker, John Skar and John Keller, with Linden Cole as our Society staff liaison. Judy was our Chairperson. On June 23, 1992, in fact, Judy testified before a Senate hearing, conducted by Senator Howard Metzenbaum, as a result of our report. We do not know if this is good news or bad news. It certainly underscores the importance of the topic. You probably have noticed increased media coverage of this topic as well. An example is an article in the June 2, 1992, issue of *The Wall Street Journal*, and a segment on CNN on the same day.

As members of this Task Force, we think there are things that can be done to improve the situation. It is important to do so since our credibility as an industry is on the line. On the other hand, we have to be realistic. Many people in our society have a mental block when it comes to mathematics. By the same token, many people buy cars who do not know anything about how the engine is put together. But they still feel they have a reason to be dissatisfied when it konks out a couple of years later and they are told that the warranty doesn't cover it. Surely the situation can be improved without having to find a way to explain engine assembly to the average person.

In my presentation, I will be talking about the views of the regulators in the U.S. on the illustration problem. You may wonder why we didn't get a regulator here to talk about that. We wanted to, but as it happens there is a National Association of Insurance Commissioners (NAIC) meeting going on at the same time as this meeting. So we contacted the regulators, collected their input and will present it here.

Our Task Force is very interested in working with the regulators on this subject. The alternative is a worsening of the present situation. We would hate to see the solution, if you want to call it that, be a dramatic and cathartic type of event like the savings and loan bailout or an Armstrong investigation. But what kinds of things led to the Armstrong investigation? Back at the turn of the century, many companies were illustrating very large 20th-year dividends, with the thought that they wouldn't really have to pay them because not many people would be around to collect the dividends or to be upset at lower dividends. There were at least a couple of problems with this. For one thing, they weren't setting up liabilities for those deferred dividends. We now have line 8 on page 3 of the NAIC Annual Statement to deal with that. Another problem was that the actual dividends often turned out to be considerably less than illustrated. Yet some of the companies, even as they were paying those lower dividends, were still illustrating the higher ones on new business. In simplest terms, people were paying for insurance on the strength of quasi-promises, the details of which they didn't fully understand. Ultimately the regulators intervened and stopped such products from being sold at all, at least in New York. The question, of course, is whether that sort of thing could happen again.

There are more recent parallels as well. One of my coworkers recently mentioned to me that back in the late 1940s and early 1950s, it was a common assignment for fledgling actuarial students to compose explanatory letters to policyholders who had written in to complain that the dividends on the 20- or 30-year endowments they had bought had not materialized. This was, of course, due to the low interest rates of the 1930s and 1940s.

Thus, both common sense and history tell us that at some point regulators will intervene and take strong measures, if the industry itself does not institute sufficient measures to deal with problems of this nature. And we could well be dealing with federal as well as state authorities. Who can forget the Federal Trade Commission's foray into life insurance in the mid-1970s, when they pronounced that the average life insurance consumer was getting only a 1.3% return on his or her money. If the Feds were to become heavily involved in the illustration issue, we could again be forced to defend ourselves in public against simplistic and sensational statements like that. As Judy will tell you later, we may have already reached that stage, given Senator Metzenbaum's interest in this subject, culminating in the hearings.

Let me turn now to the subject of persistency bonuses or enhancements. These items are a hot button for a number of regulators. I think it's important to point out that the charge of our Task Force was not so broad in scope as to permit us to pass judgment on issues of policy design. Rather we took policy design as a given and addressed the issue of how these policy provisions are being illustrated, and whether those illustration practices may need to be changed. If our Task Force had concluded that persistency bonuses were inherently deceptive and impossible to illustrate in a nonmisleading way, then we might have been forced to make a statement about policy design, but I do not think any of us felt that way.

This may be a subtle distinction, but one that has to be kept in mind. I had to keep it in mind myself as I read the letters of comment from regulators, expressing their concerns about persistency bonuses. Were they deploring the bonuses themselves or just the way the bonuses were being illustrated? The answer might be different in different cases, and certainly there are different concerns when the bonuses are guaranteed than when they are not guaranteed. Even when they are guaranteed, however, there are legitimate concerns, like the smoothness test and equity questions.

As much as possible, I will try to state the regulators' views verbatim to avoid the chance of my misrepresenting their views.

In a September 27, 1991 letter to John Montgomery, Ted Becker of the Texas department had the following to say about enhancements. This was in the context of a dialogue about the second Standard Nonforfeiture Law. He said, "Assuming an environment where companies have considerable freedom to illustrate nonguaranteed enhancements, does this environment encourage companies to make benefits nonguaranteed (rather than guaranteed) for the purpose of avoiding the need to provide nonforfeiture benefits which anticipate the nonguaranteed enhancements? Should the concept of illustrating nonguaranteed benefits at issue be limited to cases where the absence of the guarantee would be specifically for the sake of financial prudence and maintaining solvency? Two: Is the concept of building up a future nonguaranteed enhancement over a period of several years consistent with the basic principles of nonparticipating policies? When Universal Life policies were first presented to regulators here in Texas, the argument was made that these policies did not seek to distribute past profits or recoup past losses. How can nonguaranteed enhancements which are illustrated at issue and applicable years ahead in the future be consistent with the nonparticipating principle of not looking back to distribute past profits?"

Harry Marble of Maryland wrote a letter along similar lines. As I said a minute ago, some of these comments are aimed more at product design than at illustrations per se and are therefore outside our scope. But they do demonstrate a keen concern about enhancements. Early drafts of the second Standard Nonforfeiture Law actually contained language that sought to regulate illustration practices. I'm referring now to Section 15. This language is no longer there. A separate model regulation about enhancements is now the planned approach, as I understand it.

At the NAIC meeting in Houston in December 1991, John Montgomery expressed great interest in the work of our Task Force. But he voiced concerned over the possibility that the Society and the American Academy of Actuaries might be working on the issue somewhat independently of each other. Our response was to assure him that we would immediately seek liaison with the Academy and with the Canadian Institute of Actuaries (CIA) for that matter. We have done that. Our contact person at the Academy is Michael Roscoe, and our Canadian contact is Steve Prince. We have included them in our conference calls, as well as sending them draft copies of our report for review. Mr. Montgomery said that in his view, the actuarial profession had about one year to come up with a concrete proposal. Given that we completed our final report in May 1992, we should be within Mr. Montgomery's timetable if the Academy can now act swiftly. At the January 1992 Academy Board Meeting, there was some talk of getting Academy action going immediately rather than waiting for our Task Force's final report, but the Academy was prevailed upon to wait until spring. My point is that we have a cooperative spirit between the Society and the Academy on this, and it goes in both directions. For example, the Academy is working on a smoothness test, and we were invited to send a representative to the May 7, 1992, meeting where this was discussed.

At any rate, it is our understanding that we had better come up with something soon. If we don't, the regulators will, and we won't like what they come up with.

Incidently, another concern of the regulators that is beyond the scope of our paper is that of agent-created illustrations. We knew that this was a very real problem, but it was made clear to us that we should limit our attention to company-sanctioned illustration practices. Logically it makes sense to get one's house in order in the home office before attempting to rein in the field. Our final report acknowledges the problem of agent-created illustrations and recommends that this be studied by another group.

John Montgomery has given us good advice about our work. Let me mention also the feedback we got from a couple of other regulators in California, John Gilchrist and Hal Phillips. Both of them were kind enough to send us letters of comment about our initial draft.

Quoting first from Mr. Gilchrist's letter: "Universal Life and conventional participating plans are really quite different. Requirements for Universal Life are destroyed by critics from the participating point of view, and vice versa. Should not different requirements be set for each product type? There's also the interesting two-tier annuity, which may require a different approach. Two: It might be interesting . . . to consider precisely the very minimum disclosure requirements of interest to the consumer, or at least what we think would be of interest to the consumer. I would suggest the premium, the death benefit, the cash surrender value, and the term of each of the components. What is guaranteed would be the most important, and such numbers should be in the only boldface type in the illustration, and no smaller than any other material other than captions."

Use of boldface type to emphasize particular numbers or words was one of the ideas mentioned in our paper. We appreciated Mr. Gilchrist's comment on this idea. I do not believe we received very many comments about that particular point. As to his comment about two-tier annuities, it should be noted that at its Houston meeting, the Life Insurance Committee of the NAIC approved adoption of a new two-tier annuity model regulation and a two-tier annuity disclosure form.

Hal Phillips also wrote us a couple of very interesting letters. First, from his September 17, 1991 letter to us: "One: Improvements in the whole illustration scene could be very productive in reducing complaints. This is important to company costs, now that the California department is charging the company to process each complaint. Two: Strengthening the illustration process would involve tough actuarial standards, education of the field staffs in what an illustration is and is not, and education of the public on the ins and outs of illustrations. I could see an ACLI campaign. Three: This is a very important subject touching on even the credibility of the life insurance industry. Four: Where there are changes from time of original sales presentation to actual issue, a new illustration should perhaps be prepared based on what was actually issued. The agent should be required to explain these differences, for example, mortality class, premium level and frequency, amount of insurance, etc. Five: Should a new illustration be required, for example, every five years, or each time assumptions change, or on request? This could be accompanied by a brief note explaining why the data is different from that provided at time of sale."

I think it is fair to say that Mr. Phillips envisions, as our Task Force did, a solution that comprises a combination of regulatory action, actuarial standards, and individual company and agent efforts. This would include a lot of education.

Hal was also kind enough to take a look at the complaints received by the California department in the preceding year. He confined his attention to life insurance and annuities. Of the 80 complaints he selected at random, 35 pertained to illustrations; of those 35, 16 were from people who thought they were buying a savings plan or an annuity, only to find out later that they had bought a life insurance policy. So the kinds of misunderstandings and confusion that exist out there may be even more basic than we realized. Our Task Force was surprised by that. In a way, it made some of the points in our paper seem a bit esoteric.

On the other hand, one might argue that there really are not that many complaints about life insurance. In 1990 in the State of Illinois, for example, there was only 1 complaint to the insurance department for every 10,000 policies in force. This is an impressive result, and one to be proud of. But for every upset person who writes to the state insurance department, there are probably several upset people who do not. As Joe Belth recently reminded me quite forcefully, the vast majority of victims of improper illustration practices do not know now or maybe will never realize that they are even victims. In other words, this is a particularly insidious kind of situation.

Some of the comments that we have heard from regulators about the illustration situation suggest feelings of, if not outright despair, growing frustration. A couple of them spoke sadly of the futility of regulating an illustration when the real issues involve the agent or the company. Larry Gorski of the Illinois department mentioned that in states that do not regulate advertising or promotional materials, misleading statements can be rampant in those materials even if the illustrations are made pure.

Speaking of Mr. Gorski, let me briefly recount my conversation with him about these issues. Briefly, his view is that the problem is a very fundamental one of actuaries in ivory towers creating products that are simply too complex for the average consumer to have any chance of being able to understand. People simply do not comprehend, for example, that interest rates shown in the illustrations are not guaranteed. My sense from talking to Larry is that he probably would say that our report does not go far enough. He lamented the current state of affairs, commented that the solution may ultimately have to be something as radical as outlawing the illustration of anything that is not guaranteed, which would be regrettable.

Larry also said that he has been sounding out some of his fellow regulators about an idea he has, which he loosely refers to as a "Surgeon General" type of warning. This would warn prospective buyers that the consumption of this product may entail risk that could be harmful to their future financial health.

I also asked Larry about his reaction to a couple of particular ideas mentioned in our report. On the question of whether illustrations contain too many numbers and tend to confuse people, he had mixed feelings. He said that sometimes this is true, but on the other hand, sometimes important numbers are missing. On the question of whether historical data should be provided to consumers to help them in their buying decision, he said that from a regulatory point of view, this would be impractical and unfair, especially for new companies with no track record. Larry's other big areas of concern are two-tier annuities and enhancements, which I have already discussed.

I talked two weeks ago with Ted Becker from the Texas department. Earlier I quoted from a letter he had written giving his concerns on enhancements. Ted is also very concerned about the advertising of nonguaranteed numbers. These concerns could lead to the conclusion that perhaps illustrations of nonguaranteed numbers should not be allowed at all. Ted also has a concern about the treatment of riders on illustrations. As I understood him, he feels that riders really should be left out and handled as a separate discussion between the agent and the client. His concern seems to be that the riders may be obscuring the performance of the underlying policy.

Ted also took the trouble to fax me a copy of minutes from a December 1989 NAIC Product Development Task Force Meeting, at which consumer disclosure was discussed at great length. A standard "fill in the blanks" type of form, entitled "Policy Information for Applicant," was proposed in that meeting. It was very lengthy. Subsequently one state, Minnesota, adopted a shortened version of it.

At the Houston NAIC meeting, one regulator responded favorably to one of the more minor ideas in our paper. This was an optional idea that we called "Illustrations As Road Maps." The concept is that instead of letting the actual performance of a Universal Life policy diverge over time further and further from what was originally illustrated, you could send policyholders a notice each year on the anniversary, if the results are below what was illustrated. A letter would state the need to pay an additional amount to get back to what was illustrated, because interest rates are lower. This would have two advantages. First, it would keep people on track with their illustrations. Second, it would help people understand the workings of their universal life policy. So we did get one favorable comment on that idea.

Let me wrap up my comments by mentioning that at the Houston NAIC meeting, one regulator said that maybe illustrations should just be outlawed altogether. I hope it doesn't come to that. Our best chance to avoid having a draconian solution imposed on us is to do something proactive and meaningful on our own.

MS. JUDY FAUCETT: I am here to discuss the work of the Task Force for Research on Life Insurance Sales Illustration Practices. I'm happy to report that our final report was received by the Board of Governors of the Society on June 10, 1992. We were discharged with the great gratitude and relief of the Board. Our final report will be published in the *TSA 1991-92 Reports*.

Our Task Force was formed about a year and a half ago. The motivation that Daphne Bartlett had in organizing this Task Force, and that we had as Task Force members, was the belief that problems exist with life insurance sales illustrations. Current regulations and required disclosures have not solved the problems. They may even have contributed to some of them. Finally we believe that actuaries should contribute to solving these problems, because in all likelihood there were some things that we did along the way that may have helped to contribute to these problems.

I'd like to point out at this time, just to remind everybody of the distinction, that the Society of Actuaries is responsible for research and education. Therefore, we are a research Task Force that was charged with researching current practices and developing possible changes to illustration practices. It is the role of the American Academy of Actuaries and the Canadian Institute of Actuaries to actually take those alternatives that we have identified and determine which ones can be developed into some form of regulation, required disclosure, standard of practice, or whatever. Or to pass them on to whatever organization they should be passed on to.

Our scope was to research illustration practices from the perspective of the consumer. As Ben indicated, we limited our research to illustrations that are provided by the carrier. We wanted to come out with our report within a year to a year and a half, and we were very concerned that if we tried to catalog everything going on in the field, it would be a five-year research study. We still think that a longer, more comprehensive study should be done.

We limited our research to individual life insurance and annuities, excluding variable products which are regulated through SEC. As part of our research, we contacted 87 companies, and the responses of that survey are included in the Task Force report.

We also contacted some regulators to get their perceptions of where we stand with illustration packages today. First, they have a concern with product features. It is not clear whether they are concerned with the product features themselves or the illustration of those features. They are seeing an increase in the number of complaints, particularly in the areas of "vanishing premiums." These are largely due to decreases in interest rates credited on universal life policies and declining dividend scales. Second, they are also very concerned about point-of-sale misrepresentation, which is why they wonder if all of these illustration problems can ever be fully resolved. After all, nobody can be there with the agent at the point of sale.

We heard some examples that a regulator cited or that we had seen as a result of recent litigation. There were cases where agents had written clients letters telling them that a vanishing premium policy was indeed a policy that was fully paid up. Another letter, which I would love to have a copy of, told a client that the dividends were fully guaranteed by the company. Another one was written in 1991, where an agent told a client that if you look at historical analysis performed by Best's, the company dividends have always been 20-30% higher than was originally illustrated at point of sale. Therefore, you can take the numbers that are on this illustration and assume that actual results will be at a minimum 20-30% higher, and maybe as much as 50% or even double what they have shown. Finally, there was something a little on the esoteric side. A client was told that the income to an executive is tax-free when the corporation owns the policy and the executive gets income out of it.

From the standpoint of the consumer, we tried to identify what we thought were three major problems. We evaluated the responses that we got back from the carriers, who were actually very candid with us in sharing information about the kinds of questions and complaints they were getting from their policyholders. Summarizing, it became clear that consumers do not understand which values are guaranteed. Even if you have columns that clearly state which are the guaranteed values, they do not understand what is guaranteed. Further, they cannot determine if the underlying assumptions are reasonable. I'm concerned that even if we did disclose the underlying assumptions, they still wouldn't be able to determine whether they are reasonable. Further, most consumers do not carefully review the footnotes and other disclosures, which often disclose important information about the operation of the contract and the limitations on any of the policy guarantees. From the companies' perspective, they are frustrated because they have limited control over the illustration process, because of the flexibility given to the field. Agents can tailor illustrations to be whatever they want them to be out in the field. Further, a good number of them have the ability to create their own illustrations. Without the company being there at point of sale, there is no way that they can be sure that all of the information is correctly conveyed.

Companies have considerable discretion in setting the nonguaranteed elements inside of the contract. There are standards of practice relative to setting nonguaranteed elements, but they give the company a great deal of latitude. If you look at the underlying assumptions for Company A, Company B and Company C, you may find that they are on the full spectrum from very conservative to very aggressive, in terms of deliverability to the consumer. This is something that a consumer never sees, the relative conservatism of the underlying assumptions on nonguaranteed elements.

Further, companies have designed very complex products. It's not clear whether that means that actuaries have gotten better in terms of delivering products to consumers that really meet their needs, or whether the complexity is merely just another way of obfuscating what's really going on inside the contract.

From the agents' point of view, the agents may not understand the product or its illustration. I was in a meeting where I asked an agent about the interest rate that was shown on the illustration, and he didn't know whether that was the interest rate before or after the bonus was paid. He then turned to the person sitting next to him, who was representing the company, and that person wasn't sure what the interest rate was either. The agent, as a result of not understanding the illustration, may misrepresent the product to the consumer. Finally, agents may not have the expertise for that particular market, but they believe that having the illustration in front of them makes them capable of selling to the market.

The major findings of our Task Force are not particularly earth-shattering. They are things that any actuary knows. The first is that there are significant variations in risk associated with the nonguaranteed elements from company-to-company. You can't compare Company A with Company B and assume that you are comparing apples with apples in all cases. There is no disclosure on the illustration or even in the annual statement that would allow a consumer, or a third-party user of illustrations, to evaluate the relative risk associated with the nonguaranteed elements illustrated. Further, there is limited disclosure of unique product features.

One of the major points of our Task Force report was to understand the different uses for life insurance illustrations. We came up with two types of uses and creatively called them Type A and Type B. Type A uses demonstrate the operation of the policy. They can be used to demonstrate sensitivity under alternative scenarios. Type A illustrations demonstrate how particular concepts operate such as vanishing premium or deferred compensation. A Type B use is one where a consumer tries to project likely future performance or uses illustrations as a basis to compare products.

In order to do a Type B analysis, you must consider a number of contingent factors. You have to be able to evaluate the likelihood of future economic events. Once you have done that, you need to be able to measure certain companies' specific risks, such as investment risks, mortality risk, and expense risk. Then there is the measurement of the product-specific risk, to the extent that you have a product that has a unique product feature such as persistency bonuses, or where you are projecting an improvement in mortality. The fourth type of event that you have to be able to measure is the consumer response to future events. If you have a product that has a very large persistency bonus in the 20th year, you have to make an assumption about the likelihood of a change in consumer behavior in terms of retaining that particular policy.

The conclusion that we came to is that Type B usage is inappropriate unless the illustration includes a measure of the relative risk. Many of the comments that we received to the preliminary draft of our report indicated that this was a very naive conclusion to draw, something that's very easy for actuaries to say. We do not believe that just because we say that Type B usage is inappropriate, all of a sudden people are going to change the way they use life insurance illustrations. We also recognize that there is a need to find a better methodology to measure different products and different companies, something meaningful that can be given to consumers and third-party users of illustrations.

We came up with 23 alternatives to current illustration practices. They can be categorized in four different areas. The first deals with standards, disclosures and regulations. The second deals with educational efforts. The third category is optional improvements that companies could undertake voluntarily. The fourth consists of areas for continuing research.

One of the things we took a look at was the possibility of using some kind of standardized assumptions for illustrations. We found a couple of models that might be of interest. The Australian and the variable life models are somewhat similar in that they both set the earned rate assumptions. Then a company basically knocks off whatever their spread is and illustrates what rate would be credited if this is the ongoing earned rate environment.

In Australia, illustrations are normally required at two interest rates. The higher rate cannot exceed a formula based on 10-year Treasury bonds, while the lower rate cannot exceed 80% of the higher rate. An illustration at an intermediate interest rate is not allowed, presumably because if you showed three rates, everybody would assume that the middle rate would be the best estimate of what was going to be the experience over the long term. They chose to go with a high rate and a low rate, indexed to Treasury bonds.

One of the interesting things about the Australian model is that in addition to demonstrating a different earned rate assumption, you're also required to illustrate the impact of inflation over the same period of time, at a rate consistent with the interest rate assumption. That helps to take away from that startling growth in numbers as the effect of compound interest takes you 50 years out.

With the Australian model, all of the other assumptions for the product are product-specific; that is, you use the companies' own mortality and expense charges, with no standardization of those elements.

A stricter variation is the U.K. model, where they set the interest rate, based on industry standards, and also tell you what the mortality rates and the expense charges are. You as a carrier are allowed to put in your premium, and then show under their assumptions how your premium would grow over the illustration period.

We certainly do not recommend anything that goes as far as the U.K. model, because we do not think that that's particularly helpful to the consumer. But it is interesting to note that when the Australians adopted their recently revised model for illustrations, there was an implicit threat that if this did not work to prevent some of the illustration gimmickry that was going on, they might be looking at something as standardized as the U.K. model.

We asked survey participants for ideas about improving sales illustrations. Respondents showed a great deal of interest in the disclosures on the illustration and how they might be used to help the consumer. One of the things that was often mentioned was that we should disclose the required assumed earned interest rates, so that the consumer could evaluate how likely it is that the interest rate could be achieved. Now as each of you know, there are problems with that. You must have different kinds of disclosures for new money rate products than for portfolio rate products. Consumers might not understand the differences. One person suggested that we simply require that all companies grade to the same long-term interest rate as an alternative to disclosing the assumed interest rate.

The second thing that was discussed from the standpoint of disclosure was the relationship of policy assumptions to actual experience. One of the concerns is that companies are predicting or projecting improvements from their current experience into their illustrations. Therefore consumers have a right to know how much of a leap of faith it will take for them to believe that the company will actually get to that point. By disclosing where the companies are currently, consumers might have a better way of knowing whether those assumptions are realizable.

Everyone feels strongly that any unique policy feature should be disclosed. We should try to find a way that discloses it in the English language that can be understood by someone who is not knowledgeable in the insurance industry.

We also wanted to recognize that there is a difference between a concept and a policy illustration. A concept is something like deferred compensation or split dollar. Those have a different kind of use than a pure policy illustration.

Relative to standardized assumptions or different kinds of disclosures, it is not clear whether this is the solution or whether we are looking at enhanced standards of practice for actuaries, so that there is less flexibility in how certain nonguaranteed elements are developed. But that is certainly something that both the Canadian Institute and the American Academy are going to have to deal with over the next couple of years.

We think that major educational efforts are needed. Consumers, third-party users of illustration, home office management, and agents need to understand the appropriate uses of illustrations, and the limitations of illustrations. Illustrations, as everyone in this profession knows, are merely a projection of what policy values would develop under one set of assumptions. They are not a prediction of what is actually going to happen, but a demonstration of what can happen under one set of assumptions. Certainly one thing that will help consumers to understand that there is a broad spectrum of possible outcomes is to require some form of sensitivity testing to be done as part of the illustration process at point of sale. Thus, if you illustrate the current scale, another and preferably a lower scale should be illustrated as well. In that way, consumers can really see that as interest rates go down, the vanishing premium period gets longer or that the values that build up inside the contract are not as great.

Some of the litigation that has developed as a result of the high interest rates in the mid-1980s, dropping as they have through 1992, has been because the consumer just did not understand the degree of volatility that could occur. Back in the mid-1980s, we did not have the ability to illustrate alternative dividend scales, although we might have been able to illustrate alternative interest rates under universal life.

We thought about having in-force illustrations as annual updates. That was an idea that no one was particularly enthusiastic about. They didn't want to have to deal with reminding the customer yet again, year after year, that they had bought a life insurance policy and maybe it was time to think about shopping it around. They thought that it would actually be more confusing to the consumer unless, of course, it was delivered by the agent, who would be able to explain to them what was really going on with this illustration.

One of the areas that people were very positive about was a consumer brochure on appropriate uses for life insurance illustrations that might be able to be combined with the current booklet on life insurance that is required to be given to the consumer at point of sale. My concern is that if we did that, it probably would not be carefully read by the consumer.

There are a number of optional improvements that we could consider for illustrations. One is a consumer signature. One of the things that we saw in a number of illustrations was a signature page that the company had inserted, where the customers represent that they have carefully reviewed and understood the illustration presented to them. Certainly it might make consumers think twice about what kinds of questions they should be asking at point of sale, if they have to sign such a disclosure. There are several such things which we think companies could implement on their own, without regulation.

Providing historical data at point of sale might be of value to the consumer. Certainly knowing what a company's track record has been is as good as knowing what it is projecting for the future. The problem with this is that a number of the policies that we sell today are different from policies 20 years ago. It's not clear that conclusions you would draw from reviewing historical experience would be valid for drawing conclusions about what will happen in the future. Of course, it would be unfair to companies that are relatively new or that are getting into a market for the first time.

We also suggested that companies could use graphics as a supplement to the illustrations, to help people who feel threatened by a display of numbers. Showing them a picture of how the policy operates over time would help them to understand what is going on.

Finally, there were some changes that companies could make to avoid the illusion of precision. For example, on a $10 million-policy illustration, we would *not* show values for the next 50 years to the nearest dollar. Someone suggested rounding to the nearest hundred or the nearest thousand. Someone else suggested that we carry things to three or four significant digits and show zeros after that, to try to demonstrate that this is just an estimate. Another thing that was suggested was that perhaps after 20 years, we only show quinquennial or decennial values, unless there was something unique in the contract's operation, something you really need to show every year beyond that point. One of the things that such precision conveys to consumers is that this is more than just a projection of what might happen under a given set of assumptions. It appears so precise even going out to 50 years.

We think that there are areas for continuing research on the part of the Society. Clearly, we need to look at the question of how insurance policies should be compared. In addition, we should look for a measure of performance that can incorporate the relative risk among the underlying assumptions, to give the consumer some idea of the realizability of those cash values or death benefits that they are seeing.

It may appear that there are a lot of changes that need to occur with respect to illustrations. It was the general conclusion of the Task Force that companies are generally making a good-faith effort to communicate as clearly with the consumer as they possibly can. However, insurance contracts are very complex. Someone suggested that what we needed was a prospectus for consumers to better understand their purchases. We think it would be very, very difficult for the consumer to really understand a prospectus. However, they could take comfort from all of the due diligence in review that would have to go into the prospectus, to say that gosh, if they passed this kind of standard maybe it's O.K.

The bottom line is, however, that we need to do things that will help the consumer understand what is guaranteed and what is not guaranteed in the policy. Consumers would certainly benefit from more sensitivity analysis than they are getting now. They need to understand that nonguaranteed means exactly that: that as the conditions change, the performance of the contract is certainly going to change. We need to make sure that they understand the impact that this will have on their policy, that an illustration is not etched in stone.

MR. ALAN CUTLER: At Southwestern Life, we recently made it a requirement that when we receive an application, an illustration must come with it. Of course, it has to match the policy. If it doesn't match the policy summary, we send it back to the agent. This has helped us a lot, in the sense that we do not get nearly the complaints that we used to get, about agents illustrating 12% interest and all that. This is a good step for companies that do not do that. It's helped us a lot. We have been doing it for about a year and a half.

MR. BOCK: We started doing that at Transamerica as well, with similar results, fewer complaints.

MR. KEVIN R. BRIMMER: I have two questions. You alluded to disclosing earned rates for different policies. My question concerns annuities. Is there any standard as to whether the rate to be disclosed should be a nominal rate or an effective rate? Then, at the risk of becoming too esoteric, in terms of investment generation products, is it appropriate to quote a blend of the different rates that are being earned on all the different buckets in the annuity, in the different units? Or should all the different rates be quoted independently?

MS. FAUCETT: I forgot to note that we didn't address annuities in our Task Force work. The questions that you raised are very good ones, ones that must be dealt with not only for annuities but also for life insurance policies. It is something that I hope that both the Academy and the CIA will address.

I should mention where we go from here. Our Task Force was dismissed with the thanks of the Society. I have met with the Life Practice Council of the Academy, and we agreed to roll our Task Force under the Academy umbrella, adding some people from the Academy who are well versed in dealing with regulators and standards of practice. We will try to come up with a game plan of changes to illustration practices that extends all the way from disclosure regulation to educational effort and how we would go about them. We would strive for a framework for positive change for illustrations that could be presented to the Academy by the end of 1992. It is my understanding that the Canadian Institute has set up a committee that will, among other things, receive our report for review and come up with its own recommendations about changes in practice that should occur there.

MS. BARBARA J. LAUTZENHEISER: I am consistently struggling with myself over two dichotomous principles. One is that I see the life insurance and annuity products as able to solve a lot of the problems that we will have demographically and socially in the future. We can encourage people to provide for their own financial security individually. If we do not allow flexibility of product design and illustrations to encourage people to spend their money to do that, we're going to have long-term societal programs, mostly because of the breakdown of the demographics as well as the longer life expectancies that are out there. So I very much want to make sure we maintain the flexibility of product design and illustrations to encourage people to buy.

By the same token, I am concerned about people not understanding what they have or remembering what they have. There have been times when I do not remember exactly what I have without going back to the contract. My biggest concern is how to accomplish this. If we move toward standardization of illustrations, or mostly standardization of product design, I think we will eliminate the ability of the insurance product to provide some of those benefits that are needed out there. So I'm concerned about that.

I know your committee struggled to find the right solutions. I have two questions in that regard. Did you consider utilizing focus groups to find out how people really think? If you use complaints, you get a one-sided approach of what people think.

Some of those people want something for nothing. Having dealt in some of the expert testimony, as I suspect you have, you discover people who are fighting for something that they really didn't know they had in the first place, but who are using a litigation process to get it. So the complaints have a bias in and of themselves. Did the Society or would the Academy consider using focus groups to find out how people really feel about it and what would be good?

Second, could we use some of the Society of Actuaries resources to do some educational pieces, such as a videotape? I'm not sure a booklet does it. But a videotape that talks about the Society of Actuaries, utilizing Society of Actuaries resources. We are a research body and an education body to help educate the public on why these are not guarantees, and how they should be looking at these in terms of flexibility. I'm not talking about numbers now. I'm talking about perceptions and concepts regarding the nonguaranteed elements of a contract.

MR. BOCK: Maybe I can answer the first one. We considered focus groups, but not for very long. For one thing, we were informed that we had no budget for that. Maybe that's something that could be done as this thing progresses further on.

MS. FAUCETT: We did actually have some conversations with LIMRA and other organizations that do focus groups. They suggested to us that when you bring together a focus group of people who recently bought insurance and ask them how they view the illustration during the sales process, what they are likely to parrot back to you are the things that they think you want them to say. They want to look like astute buyers of life insurance. The only way to know for sure how buyers are reacting during the sales process, and what they are looking at, and how the illustration is affecting the process, is to actually be there at the point of sale. Then, after the agent makes this big point about explaining a certain product feature, or how interest works, or how this works or that works. Pointing to numbers on the illustration, you stop the discussion and say, "Now let's think. How is this affecting your sales decision?"

We thought it was unlikely that we had enough agent friends who would be willing to take us along during the sales process to ask those kinds of questions. But I think that it is something that someone may want to consider. Perhaps the Academy and the CIA have better budgets for this than we have. It might be possible to do.

The idea of a video is an interesting one. No one has suggested videotaping anything from the Society of Actuaries before. We could have a lot of fun role-playing the illustration process and some sample situations. That could be a lot of fun. We will pass the idea along.

MR. ALAN L. IGIELSKI: I think we should consider the sophistication of the customer. For example, the products I work with are geared toward corporate-owned policies and split dollar. They often have fee-for-service brokers or consultants working with them. Obviously illustrations for these buyers are going mean something much different from illustrations marketed to individual buyers. Their agents are obviously being paid by the company, and there may be unscrupulous agents who do not have the customers' interest at heart. The disclosure requirements should be geared toward the sophistication of the buyer.

Also, notwithstanding the intrinsic merits of disclosures and Barbara Lautzenheiser's legitimate concerns about constraining the creativity of products, policies as they are now can drown people in a blizzard of paperwork, with the contract forms and illustrations. Additional disclosures may not have the desired effect of informing the buyer more. I have a feeling that in the future, we may see pressure from society for regulation of the illustration process, something more akin to the U.K. or the Australian model.

MS. FAUCETT: You commented about more sophisticated buyers. When we undertook our research, we called four or five carriers who work in the corporate-owned life insurance market to ask them if they had any problems with their customers understanding their illustrations. Did they, because they were upscale and usually had third-party advisors, understand the illustration better? The first comment that every single one of them made is that they did not understand mortality-adjusted illustrations, where you have a large group and you assume some underlying mortality table. In this situation, you are projecting death benefits from this large group of 500 or 1,000 or 5,000 lives.

One person I talked to shared the following story. He was sure that the agent had not misrepresented the set of policies comprising the case. He called the customer at the end of the first year and asked how things were and whether they were happy with the plan. The response was yes, but where is my $12 million in death benefits? The agent responded that nobody had died. "Well," said the customer, "are you holding my $12 million? Are my cash values $12 million higher? Instead of getting $12 million this year, am I getting $24 million?" So even the more sophisticated buyers still do not understand some of the more esoteric points of our illustrations. I have worked in this market for a long time, and I thought that was something they all understood. There are clearly some out there who do not.

MR. P. RANDALL LOWERY: A lot of references have been made to some of the more esoteric points, and also the need to do something in a short time frame before the regulators do something that we will not like very much. This might be one of the situations where 80% of the problems could be solved by a basic fundamental change, and then we could worry about the details later. I've always been of the opinion that most of the problems related to the interest rates and to the agent projecting different rates. It seems to me that the adoption of the Australian variable model, fixing the earned rate, addresses a big majority of the problems. Is there any possibility of going ahead and saying that is something we know needs to be done? We could worry about some of the finer points later, instead of waiting around a couple of years to try to come up with a perfect solution.

MR. DAVID H. RAYMOND: I have been talking to several people about these issues. From several sources I have gotten the opinion that interest rate games used to be almost invincible in the early years of Universal Life. Partial sophistication now has reduced their effectiveness, so that the emphasis is turning toward cost-of-insurance games. Almost nobody can understand those yet. They work wonderfully, at least for the next 10 years.

MS. FAUCETT: One of the comments we got related to that, although this is not to suggest that actuaries are into gimmickry. The suggestion was that if we solve the interest rate problem, we would just move the problem to the mortality and the expense charges. In fact, we would be giving an unfair advantage to the companies that had already done that. I do not know, but perhaps going for the interest rate would solve a substantial portion of our total problem, if we didn't unfairly treat some other companies as a result of that.

MR. IGIELSKI: These previous comments remind me of a little story. It also relates to one of the comments Judy made, that agents sometimes do not understand the policies. My mother was thinking of buying an insurance policy on my father, and she asked me to speak to her agent. I spoke to him, and it was a Universal Life policy being proposed. I asked about the crediting rate, and then I said, "What kind of cost-of-insurance (COI) deductions are there?" He didn't understand what I was talking about. I said, "Well if you think of this Universal Life policy as a box, then you pour in premiums and your interest credited, and then pull out the cost of insurance. You could credit a high rate, but then at the same time be taking out a high COI, so you would be giving with one hand and taking with the other." And he said, "I didn't realize that out of this account you're actually pulling out an amount every month to pay for the insurance, and that could vary between companies. I'll have to talk to the company about that, because I never realized that before."

MS. LAUTZENHEISER: I keep responding to what I am hearing. I guess this is why I go back to basic education. I am not sure about two points. First, I have been speaking probably for 20 years about the fact that what we sell is insurance and not a savings plan necessarily. When we start dealing with just numbers, I think we may be causing part of the problem rather than solving part of the problem. Second, I think that education is very necessary and not just for the consumers, but also for the field forces who may or may not understand everything. We are putting people out there without a complete education. We think they may have it, but they do not have it. There is, of course, a lack of common sense that we are never going to be able to offset. I am reminded of one of the illustrations I heard, early in my career, one of my little old lady stories. The little old lady's policy number was 10239, she had a $1,000 dollar policy and she sent in her premium of $102.39.

MR. BOCK: Our report advocates education not only for consumers and agents but also for home office personnel.