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SALES ILLUSTRATIONS – WE CAN'T LIVE WITH THEM, BUT WE CAN'T LIVE WITHOUT THEM!

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Panelists: BRUCE E. BOOKER
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Recorder: JOHN APRILL

- Current initiatives from various task forces (AAA, NAIC, ACLI, NALU, ASCLU)
- Have illustrations taken on a life of their own?
- What should be done about illustrations, especially by actuaries?

MS. JUDY FAUCETT: Our topic is "Sales Illustrations – We Can't Live With Them, But We Can't Live Without Them!" I am filling in for Walt Miller who is unable to be here. However, he did recruit both an interested and an interesting panel to share thoughts on illustrations. He also sent comments, so you will have the benefit of everything Walt was going to say.

Bruce Booker is a vice president and actuary with Life of Virginia in charge of product development. He has been an active participant in a number of industry and actuarial groups looking at illustrations and cost disclosure. He's a member of the American Council of Life Insurance (ACLI) Task Force on Cost Disclosure and the National Association of Insurance Commissioners (NAIC) Advisory Group on Illustrations. We also have Bob Nelson who is a vice president with the Grace Mayer Agency in Omaha, Nebraska. Bob has been very active in professional activities both within Nebraska and nationally. I know him as the chairperson of the National Association of Life Underwriters (NALU) Task Force on Illustrations.

As former chairperson of the Society Task Force on Illustrations and chair of the Academy Task Force on Illustrations, I'd like to give you an update of what our activities have been and share with you where I think this is all going. Recently, I was reading a mystery novel that starts off with an anecdote about a man who dies and goes down to hell. As he is standing in line to be processed by the gatekeeper, he notices couples frolicking and cavorting and having a really good time. He concludes that hell isn't going to be so bad at all; in fact, it could be a whole lot of fun. At the front of the line, the gatekeeper checks his list and says, "No, this isn't your time yet, you're going back to earth." He returns to earth and of course he doesn't see any reason to change his ways. Five years later his time was really up and he goes back down in hell, but this time he sees everybody standing neck deep in fire and brimstone. When he gets up to the gatekeeper he says, "This isn't the way I remember it five years ago." The gatekeeper says to him, "Well, you were a prospect then, you're a client now."

I don't need to explain to you how that fits what we're facing today, and perhaps if we had been able to keep up that aura of frolicking and cavorting, we wouldn't have any problems with illustrations.

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The Academy Task Force on Illustrations is the successor group to the Society's Research Committee on Illustrations. The charge of the Academy Task Force was to review the report of the Society, and to develop specific recommendations with a focus on those changes that would benefit consumers and third-party users of illustrations. Along the way, we have been coordinating with various industry groups that are considering illustration issues and reacting to alternative proposals that have been developed by these groups.

I thought it would be helpful to map out the chronology of events in the U.S. (The CIA is concurrently working on illustration issues and has taken a slightly different approach.) Our preliminary report was released in 1991. We got a number of comments from within the profession and from other interested parties. In fact, for awhile it was the biggest seller at the Society office. In June 1992, the final report of the SOA task force was released. At about that same time, Senator Howard M. Metzenbaum announced hearings on illustration abuses. In the fall of 1992, the American Society of CLU and ChFC released the Illustration Questionnaire (IQ). Bruce will talk about it, and Walt sent me a few comments to read for you on the IQ. Walt has been very active with the IQ as has Jim Reiskytl.

Also in the fall, Senator Metzenbaum sent a letter to the NAIC describing the problems that he saw with today's illustrations based on the hearings that he held in June. The main problems that he saw were that buyers had no way to really understand what was and wasn't guaranteed in the illustration. Buyers didn't really understand the true cost of the insurance, and there was no way to help the consumer understand what a good replacement was and wasn't. In response to that letter, the NAIC formed a working committee on life disclosure that was charged with responding to Senator Metzenbaum's letter and with developing possible regulatory changes to illustration practices.

Also in the fall of 1992, we saw three other industry task forces being formed: the NALU Task Force, the reconstitution of the ACLI Task Force on Cost Disclosure, and the NAIC Advisory Group working with the NAIC Working Committee on Disclosure. In December of 1992, the Academy delivered its preliminary report to the NAIC, which will be the focus of my comments. In spring 1993, the Actuarial Standards Board (ASB) held a hearing on illustration practices to determine if changes to our standards of practice were needed. We also had NALU reporting to the NAIC on the results of its task force's work in the area of illustrations. We are hoping that the NAIC will release an exposure draft of its proposed changes so that the changes could be implemented by the end of the year (or at least enacted) for implementation by companies probably sometime in 1995.

In developing our recommendations within the Academy task force, we developed certain guiding principles for the disclosure that we thought were necessary. First and foremost, we thought it was important to disclose or demonstrate those policy features that have a material impact on the cost or benefits of the policy and the years in which those changes occur. It's not important just to show the year in which the change occurs, but also a year or two before and a year or two after so that the buyer has some sense as to how the operation of the contract is changing at that point. It also is important to disclose or demonstrate the sensitivity to changes in assumptions. Buyers need to understand that the current scale does not necessarily reflect what we think is going to happen over the next 40 years, and there can be some variations in those nonguaranteed values. We should also be disclosing the premium that is required to guarantee the benefits that are being illustrated. This responds directly to Senator Metzenbaum's point that buyers need to know what the premiums are to maintain that coverage in force. Lastly, we should disclose what a consumer can reasonably understand. Disclosing all of the assumptions underlying the illustration and how they relate to the company's current experience may help the consulting actuary who is reviewing the particular illustration, but it's certainly not going to help the average consumer. We need to focus on what the consumer can understand.

The area that has received the most attention and criticism has been the area of vanishing premium. Our recommendations focused on adequate disclosure of the concept. The buyer must be aware that there is no guarantee on the vanish point. Even if the policy does vanish as illustrated, the policy is not guaranteed to be paid up at that point and premiums can reemerge if experience changes. The values that are illustrated should be consistent with the premium and benefit patterns that are being shown. This is already a requirement on flexible premium policies, but we have seen illustrations of fixed premium contracts where the current values are based on the premium pattern that's being shown, but the guaranteed values assume annual premiums are paid every year. This certainly gives the buyer some misimpression as to how much guarantee is really in those policies. We should disclose the premiums that are required to maintain the policy in force on a guaranteed basis. This gets back to making sure that they understand that premiums are required for 20 years or for life, whatever the underlying policy requires. Because the vanish occurs in ten years, it isn't going to maintain the policy in force on a guaranteed basis.

We also should be doing something to sensitize the policyholder to how changes in the underlying assumptions can affect the vanish. The problem that our task force noted here is that not all policies are sensitive to the same degree to the different nonguaranteed elements in the policies; there is a lack of linearity. If a policy requires one additional premium if interest rates drop 100 basis points, it's probably going to require more than four additional premiums if interest rates drop 400 basis points.

This comment applies to second-to-die policies that have a change in the guaranteed values upon the first death. We thought it was important for the consumer to know about such a policy design feature; and, if the values did change, we should describe how the value changed in the illustrated basis for the first death. I've seen some policies where the most conservative way to illustrate the policy is to project both insureds living to age 99; then there are others where killing them off early seems to produce a more conservative result. It seems to me that a buyer looking at this kind of design really needs to see the contract illustrated both ways. He certainly needs to understand what happens at the first death.

A number of the second-to-die policies today and certainly some single life policies as well, are being sold on a modular or blended basis. This is where you have some combination of the base policy term riders or term dividend benefits plus some paid-up additions or accumulation riders that are all blended together, and that every policy looks a little bit different from every other policy. We thought it was important that the buyer receive adequate disclosure of the modular structure particularly since the term components may add significantly to policy sensitivity when the underlying assumptions change. The sensitivity seems to change exponentially if you're also illustrating a vanish on top of that. The illustration again needs to be consistent with the premium and benefit patterns. The buyer should be aware of the premiums required to maintain the policy in force on a guaranteed basis and needs to have some sense of the sensitivity of this policy as assumptions change.

Recently someone shared with me a cover sheet on second-to-die policies that his company does for its clients. They looked at four different blends of base policy and term and showed the buyer the different premiums that are required under each of those scenarios, how many years the premiums must be paid under current interest rate assumptions before the policy premiums will vanish, and how many years premiums must be paid if interest rates drop 200 basis points. So in just a few numbers, they were able to clearly communicate the sensitivity of the policy to different blends of term as well as different interest rates.

We thought it was important that the life and annuity components be illustrated separately on the two-tiered policies with multiple benefit streams. It should be clear to the policyholder what they're getting at any point in time, and we shouldn't be confusing the life and annuity components.

Also, whenever current values are shown, it is important to make sure that the comparable guaranteed values are also shown.

We made a few comments on cost comparisons. We thought that a footnote should be added to each illustration that describes how illustrations should be used. This gets at the infamous type A versus type B uses. Illustrations in and of themselves cannot be used to compare products and companies given all of the differences in illustration assumptions today. Going along with this, we thought that it would be appropriate to delete the interest-adjusted cost indexes from the point-of-sale illustration. Having the cost index there gives that superficial aura that we believe illustrations can be used to develop some kind of cost measure that will help us in comparing the relative value of products.

We recommended that these changes be implemented as soon as possible. We have presented these recommendations to the NALU Committee, the NAIC, and the NAIC Advisory Group. It probably comes as no great surprise that most of these things were generally accepted other than deleting the interest-adjusted cost indexes. There's a real concern that if we recommend deletion of the interest-adjusted cost indexes that we are creating a vacuum unless we identify an appropriate alternative that can be used in its place. So, it is unlikely that you're going to see any recommendations coming out of the industry groups that endorse deletion of the interest-adjusted cost indexes. Everybody wants to wait and see if we can come up with a better solution to measure and compare products.

We also identified a number of short-term changes for industry consideration. We think we need a lot more input from the industry as to what is really feasible for companies to do and what is really going to help the consumer. The first one is pretty straightforward -- we need standardized notes and standardized definitions of terms that are used in the illustration. In fact, the NAIC advisory group has asked our Academy task force to come up with some recommended standardized definitions.

The next two points are items of standardization or disclosure that are being met with a fair amount of criticism within the industry. To disclose all of the underlying assumptions that go into the illustration probably is not going to be of significant value to the consumer. Standardizing the assumptions might be helpful for the consumer but it certainly doesn't help them to understand the nuances that exist between companies.

Other points that we identified were additional sensitivity analysis, the use of different print sizes or typefaces for specific notes, and changes to our actuarial standards of practice. We were particularly concerned that there really isn't a consistent definition of current experience or supportability that is used in responding to the interrogatories in the annual statement, and we thought that actuaries might benefit from such definitions.

Finally, we saw some strategic changes that needed to occur within the industry. There is a need to target educational programs at agents and company personnel, including actuaries and not just at consumers. All of these publics need to understand the appropriate uses of illustrations, and what an illustration can and cannot do, such as the type A versus the type B usage.

There should be a lot more focus on the need for in-force illustrations. The policies that we sell today have so many moving parts and require frequent monitoring on an ongoing basis to make sure that the program is remaining viable, that enough premium is going into these policies to sustain them, and that the death benefits or cash values are structured the way that the policyholder expects them to build. So, I think there's going to be a lot more focus on in-force illustrations in the future.

One of the issues has been just how many companies currently have in-force illustrations, especially companies that have less than $100 million in assets. One of the concerns has been whether creating illustrations presents some kind of hardship for the smaller companies to come up with this kind of system.

The second item that we think might help is the point-of-sale brochure. Right now we have the buyer's guide that must be given to policyholders when the policy is delivered, but it might be distributed too late to help them.

Finally, I had expected the research methodology or measures project (comparing companies and products) to be assigned to a research committee. However, it had been assigned to the Academy Task Force on Illustrations, so this is something that we're going to be working on this summer.

It's been interesting that the advisory committee meetings have focused on whether the problem is that consumers need to see more numbers or whether they need more narrative. There also are consumers who don't want numbers or who don't read well either, so we're not sure exactly how to get through to them. We heard at the March NAIC meeting that some commissioners believe consumers really don't understand that they're buying life insurance; the problem is really much more fundamental than what we had anticipated. At the April meeting of the advisory committee, we had a great deal of discussion about how to deal with this and whether we were focusing on changes that assumed too high a level of knowledge within the consumer group. As we talked about adding numbers, there was a concern that we had too many columns on multiple pieces of paper. We were concerned as to how we transition from one page to the next. If we did this strictly in a narrative form, the notes would get lost in the existing three to six pages of notes.

We came up with a new approach that is currently being evaluated for feasibility. That is, each illustration would have a cover sheet that has four to six very basic notes that set the stage for what the illustration is all about. It starts with, "This is a life insurance policy," and gives the generic name of the policy such as participating whole life, universal life, second-to-die, etc. It describes when the death benefits are paid. The cover sheet also describes the premiums that are required to be paid under the policy on a guaranteed basis. If the vanishing premium concept is shown, it would explain the concept of vanishing premium, describe how it was sensitive to the current assumptions, and describe how changes in the assumptions could affect the vanish point. It would disclose any unique features of the policy, such as persistency, bonuses, changes in the guaranteed values upon the first death, and structures of term and accumulation units in the base policy. All things would alert the consumer to some questions they should discuss with their agent so that they understand how the program is being structured and the underlying sensitivities.

It's my understanding that the NAIC Working Committee on Cost Disclosure is planning to meet in June to work on draft regulation, either revisions to existing regulation or developing a whole new regulation. There may be an exposure draft released soon. There's certainly an impetus at the NAIC level for action in 1993, and I really do think that we're going to see some regulatory changes in the very near future. With that, I'd like to turn it over to Bob Nelson who's going to share with you illustration problems from the perspective of the agent.

MR. ROBERT M. NELSON: I am an agent and I do business in Omaha, Nebraska. I'm with an independently owned property and casualty firm and I manage the life department. Since we work with more than one company, it adds to the difficulty of trying to understand the differences between companies and the products that we represent.

I'd like to begin by acknowledging that I consider it a special compliment to be able to represent the agent's point of view on the subject of sales illustrations. I want to cover the following: (1) a brief history of the NALU Task Force on Sales Illustrations and its works to date, (2) a highlight of the recommendations we have made thus far, and (3) a personal comment about the topic we're discussing.

Throughout last year, many agents were sensing the unrest over policy performance and the credibility of the sales illustrations we were using. We agents are generally the first to hear of the disappointments, the confusion, and the bitterness felt by policyholders. Consequently, we may be in a unique position to comment upon the problems associated with the same illustrations that often cause that frustration. At a meeting late last year, the presidents of the major field organizations resolved to form an industry task force to look into the problems of sales illustrations. NALU President

Steve Shaw asked in December if I would chair this new task force, a challenge I both wanted and had strong feelings about. At that time, I was already NALU's national chairperson for its Field Practices Committee (sometimes referred to as the Ethics Committee), and it's a position I still hold. For better or worse and with a lot of mixed emotions, I accepted the challenge. We called our first meeting for early January in Washington, D.C.

It was a humbling experience for me to attempt to lead this impressive lineup of professional talent. Our task force is composed of representatives from all the principal life and health insurance field organizations, and many of them are past presidents or upcoming presidents of their respective organizations. Those participating include the American Society of CLU and ChFC, the Association for Advanced Life Underwriting (AALU), the Association of Health Insurance Agents (AHIA), the General Agents and Managers Association (GAMA), the Million Dollar Round Table and of course, NALU itself. In addition, actuaries from both stock and mutual companies representing the American Academy of Actuaries and the Society of Actuaries serve on our task force. At both our January and February meetings, we relied heavily on the work already undertaken by the CLU Society, the AAA and the SOA Task Force's report.

Our task force agreed on a number of recommendations that were subsequently approved and adopted by the NALU's board of trustees. Of paramount concern to agents is the fact that illustrations may not be supportable under current actuarial standards of practice. A fundamental problem is that the illustration data that the agent and the buyers receive, while accurately reflecting current rates, may be unsupportable for even a few years into the future. Historically, illustrated dividends were understated in sales illustrations and we were spoiled, but in recent years, that doesn't seem to be the case. Our task force feels that there must be more precise definitions and stricter rules governing the definitions of supportability and current experience. We took our concerns to the ASB public hearing on March 3, 1993 in Chicago. We asked the ASB to review the current actuarial practices and help define and strengthen the definitions and rules regarding supportability of sales illustrations. We were expressing our concern not just for the existing downward interest rate market, but for all economic cycles over a long period of time.

I'd like to stress that agents don't pretend to know the answers. Sometimes it's like picking a style of an automobile: I know the model I like, I know the company I'd like to back-up the automobile I purchase, and I even enjoy using and driving it, but I don't pretend to know how the design engineers came up with all the features of the car I chose. I think the analogy comes through in the life insurance business on a very simplistic plane -- we don't have the answers that I believe the actuaries do. It is our intent to ask for your help because we're currently living with problems that lack solutions.

On March 8, I testified in Nashville at the spring meeting of the NAIC. The following are highlights of the 12 recommendations that we made at that time:

1. Require that consumers receive a supportable illustration as defined by the ASB, or a statement be prominently displayed on the illustration that the

current illustration is not supportable. Obviously a prerequisite for adopting this recommendation is a usable definition of "supportable."

2. Sensitize policyholders to material changes in the policy as illustrated by requiring a short, simplified sensitivity summary to accompany illustrations. It would contain policy data for a given amount of premium using both current and lower interest rates. If the illustration is particularly sensitive to changes in nonguaranteed elements other than interest, this fact should also be covered by the summary. If there was one thing that I wished we had done better, it was to sensitize our policyowners to the impact of change that any one element could make on the future of these policies.

3. Mandate a signed disclosure statement whereby the consumer acknowledges that he or she has read the illustration, understands it, and knows that nonguaranteed elements and dividends are not guaranteed. It seemed pretty simple to me. How could you argue with such a request? However, we were surprised that this statement met with opposition from a minority of members on our task force who pointed out that they do not use sales illustrations in their sales process. Therefore, to require a signed illustration was an unfair burden to them and those who practice like them. To meet that objective, the following was agreed upon -- if an agent does not use an illustration, then require the agent to sign a statement attesting that an illustration was not used in the sales process.

4. In order to better identify items that should be regulated as sales illustrations, precisely define the term sales illustration so that agents and companies will understand when regulations apply.

5. Make certain that a description of all policy types and all riders integral to the product being illustrated accompanies the illustration.

6 Require that illustrations show the first 20 years, year by year, plus years when significant policy changes may occur such as premium reappearance, and make every fifth or tenth year increment to maturity optional. The figures should be rounded down to the lower $100. (Now I understand that innocent little statement later ran into tremendous objections. I didn't understand the reasons though I've had them explained to me. From my perspective, I would like to soften at every opportunity that a sales illustration is not so precise that it could be construed by the consumer as a predictor of actual performance in the future. I should note that was one of the first changes that I implemented in my own practice.)

7. In the case of vanishing premium illustrations, require adequate disclosure of the vanishing concept in the illustration or footnote it as recommended by the American Academy. The language that was recently recommended by the American Society of CLU and ChFC is a good example of adequate disclosure in this area.

8. As recommended by the American Academy with respect to illustrations of second-to-die policies, require a statement as to whether the policy values

change at the first death, and if so, how they change. An illustration should display the operation of the contract when both insureds are alive and after the first death.

9. In illustrations of blended or modular policy rider combinations, require clear disclosure of the modular structure in the illustration, disclosure of the current guaranteed premium for any applicable term coverage (whether provided by riders or dividends), and illustration of the annual cost of the total death benefit for all years based on policy guarantees.

10. As recommended by the American Academy, provide that sales illustrations should not be used by themselves for comparative policy performance. We provided sample language to expand on why sales illustrations by themselves were inadequate for policy comparisons.

11. Delete the interest-adjusted cost indexes from point-of-sale illustrations and from the NAIC Model Buyer's Guide. These index numbers can be useful for historical purposes, but to use them in the illustration invites comparison, which we already concluded was an improper use of the illustration.

12. Require that if an agent provides the buyer with a self prepared or third-party vendor software illustration, it must be accompanied by a company-prepared or endorsed illustration.

All of these recommendations are the result of the task force's broad experience in the field and it's contact with consumers and their reaction to illustrations used in sale situations. Agents certainly have and will continue to have the responsibility to point out and discuss with their clients all relevant disclosures on illustrations.

As a final comment, I want to clarify that I am just an agent who entered this business nearly 20 years ago. I had then, and I have today, a great sense of pride and professionalism in what I do for, and not to, my clients. I sincerely believe we have a flawed instrument in today's sales illustrations. It is neither a reason to condemn our industry nor pretend our industry should have been immune to change, especially with the economic realities of the past few years. But we did not communicate the impact of change as well as we should have, especially the impact of change on the numbers we used in our sales illustrations. So our challenge is to learn and to respond. I sincerely believe it's a shared responsibility by all of us – agents, the actuarial profession, company leadership, regulators and even the consumer. Our biggest mistake would be to delay. I don't believe the consumer will tolerate or forgive us, let alone the regulators, if we do nothing.

MS. FAUCETT: Walt would like to have the following statement read; it is a seque into the comments that Bruce is going to make. "As the Society of Actuaries, now Academy of Actuaries, task force has said, sales illustrations should not be used by themselves to compare even similar policies in different companies. The primary reason is that the assumptions that underlie the illustrations vary widely and this makes 'apples-to-apples' comparisons virtually impossible. The American Society of CLU and ChFC has been working to do a better job of educating agents, and through them, their customers on the bases of particular sales illustrations. The latest project approved by the ASCLU board and released last year is the illustration questionnaire or IQ. This questionnaire contains a number of questions about illustration bases, not only general questions but ones relating more specifically to items like investment return, mortality, expense, and persistency. The material is heavily related to current annual statement interrogatories on bases for dividends and nonguaranteed elements, but is presented in an expanded and hopefully more readable form. Because these interrogatories are publicly available, it is believed that answers to these questions do not involve disclosure of any proprietary information."

The ASCLU is working with this questionnaire on two main fronts: (1) to encourage companies to supply their agents with answers to the IQ questions for their policies, and (2) to continue a wide-ranging educational program about the IQ. Based on the information gathered in a number of pilot teaching courses, the IQ is now being discussed at many chapter meetings and specific course material is being developed. And I can tell you from personal experience, it was absolutely amazing to watch how the agents became enlightened about insurance products, how they are designed, and how they are illustrated. They came to know that the more you know, the more you know that you don't know, which I think is good.

MR. BRUCE E. BOOKER: When Walt first called me about this meeting, I agreed to speak, but I wanted to tell you everything that was wrong with the IQ. When I put my speech together, I changed my mind. I thought I'd tell you what is right about the IQ.

The IQ when fully answered can provide agents with valuable information that they may not have been receiving from company management in the past. The value of the questions, however, depends on the design of the policy being described. Participating policies for example are generally designed with a dividend scale which is meant to return earnings and surplus no longer needed by the company. It is important for these policies that mortality, expense, and interest factors come close to the actual past experience of the company so its surplus goes as nearly as possible to those who contributed it. For participating policies, those questions are the most important ones to look at.

However, nonguaranteed elements in nonparticipating policies are generally based on currently anticipated experience which may well differ from past or current experience for reasons such as changes in underwriting practices, changes in investment strategies, changes in plan designs (e.g. it may have a large surrender charge now that makes a big difference in the policy) or even extension of recent trends in mortality or expenses into the future. For these policies, questions which seek an explanation for the anticipated differences between the illustration and current experience are important.

Also whether a policy is participating or nonparticipating, it may or may not have an account value. For those policies that have an account value, there are a lot of questions about any bonuses and the extent to which cost of insurance rates also cover expenses.

Finally, there are policies without account values such as traditional participating whole life. In these policies, the direct effect of any single nonguaranteed element cannot be determined, but questions about company practices, especially practices in classifying policies, are important. Nonetheless, the most important questions that will most likely get the shortest answers are the first two in the questionnaire:

1. Are one or more of the policies participating? Specify.
2. Are one or more of the policies nonparticipating? Specify and describe the nonguaranteed elements.

These are the questions that are needed for the policyholder and the agent to assess the risks in the illustration, and to enable "what if" illustrations. How would the policy look if certain things happened? How much risk is the policyholder taking and at what price?

Most of the rest of the questions in the IQ seemed to be looking for answers to how good this policy is and how it compares to other companies. As we've heard, illustrations can't accomplish this very well. Even with the IQ, we can't set up a confidence level or a confidence index in any particular company's illustrations, no matter what the answers are.

Besides giving agents answers to the IQ, what can an actuary do to produce happy policyholders? First, I'd like to look at what has and hasn't been done until now. In my opinion, modern disclosure stems from the results of the 1974 Society of Actuaries Committee on Cost Disclosure Methods. Questions back then were much the same as we have today – how can a buyer determine what he's getting and how can he compare policies? Back then, many people were being sold off-ledger statements which showed premiums for 20 years' cash values and dividends after 20 years. There was no method for comparing whether he should be paying a lot of money early for higher cash values or a little money for little cash values until interest adjusted indexes were developed. Now we have more sophisticated methods and we're talking about removing those indexes.

The answers back then were also much the same as they are today. We need effective disclosure, not necessarily more but better, and indeed there is no one measure of method that can usefully compare all features of competing policies. These statements were from the report in 1974. In 1975, the NAIC adopted a model disclosure law and regulation based on the results from the 1974 Society study. This regulation, among other things, mandated a summary of policy costs and benefits. However, even now, almost 20 years later, only 41 states have adopted this or any other form of required disclosure.

Since then, there have been a number of other activities. The NAIC adopted a buyer's guide in 1976 to describe what life insurance is, what it isn't, and what somebody can expect from his policy and his company. In 1983, there was a UL model regulation that included large sections on disclosure including a requirement for in-force illustrations. The cost disclosure regulation was revised in 1984 with a smoothness test put in to cut down on persistency bonuses that were guaranteed in the policy. There are NAIC model advertising rules, the standard nonforfeiture law was changed, and another different smoothness test was put in. The NAIC adopted a yield index for people who didn't like the interest-adjusted cost index. There's more annual statement disclosure. The ASB is looking at illustrations and is probably thinking about some standards of practice. We've seen the formation of the Society and Academy task forces, and the ACLU has put out a lot of stuff as well.

Finally, a big reason for a lot of the industry action right now is that Congress is looking at illustrations again. Senator Metzenbaum has sent a letter asking why we're not doing more and suggests that he will do more. If all of this has been done in the industry, why are there still problems? Do we have companies making excessive profits off the policies? I don't think so. Are expenses drastically different from those that were illustrated? No, the deferred acquisition cost (DAC) tax is the main change that I've seen. Mortality isn't worse, it's better. Has there been a shortfall in performance versus promises made by companies? Not on the guarantees, except for a few failed companies.

One problem area in a lot of policies has been interest rates. A slow cumulative, very large decline in interest rates has affected everything. Why are we getting so many complaints? Did the policyholder expect rates to stay the same forever? Did the agent or the company mislead? Did the policyholder think we were promising? He shouldn't have, I hope he didn't. So what's the surprise that vanish is extended somewhat or in some cases doubled, or that premiums reappear? If any "what if" illustrations were done originally, the policyholder should have been sensitized to the fact that things will change, and there may be big results from small changes in interest. If "what if" illustrations were done, were the changes so big that they didn't seem credible to the policyholder? A small change in interest would double the number of premiums you'd have to pay, or halve the cash value at age 65. Guarantees were usually shown but they're so far out of the money these days that nobody pays any attention to them.

The basic problem is that all of today's products, no matter what the plan, design or the company, pass much risk on to the policyholder whether it's the dividend scale, blending of face amounts, or current assumption cash values. The policyholder is taking more of the risk and the company is taking less, and we hope that's reflected in the cost to the policyholder. But what does the policyholder know, what does he think and what does he expect is going to happen in the future?

Judy told us a lot about what is going on right now. No one is rushing to adopt any of the existing models and very few of the states are doing anything to enforce current models that would certainly serve to stop any really outrageous illustration practices that are out there. Everyone does appear anxious to do something positive. No one wants to enforce the laws that exist; everyone wants to do something different to solve the problem. So the effect will be and has been to add more disclosure, more rules, more restrictions. We don't have a really good idea of what would be better; we're trying to do research on that.

So what do I think is needed? Today's disclosure is far too complex. If policyholders can't understand most illustrations even with help, what are they to do? There's information overload. The regulations we have are not being used consistently across the country. More numbers are not necessarily the answer, but maybe less are. More words are necessary to explain what's going on. The regulations, if they are changed, should force more disclosure of what the risks are and "what if" illustrations should be mandated. We have to make clear to the policyholder that the illustration is not a prediction, it does not promise what's going to happen.

If we don't do anything, the Congress is going to impose federal regulation; eventually we'll all be selling the same policy so that you can compare. It would be just like the medicare supplement business and everybody will be able to compare different companies because price will be the only difference.

Actuaries can do lots of things. We can provide the field with a clear description of the policy and how it works. We can provide a proposal system that can do what if analysis to illustrate the risks. We can provide clear, concise information on company financial soundness including the ratings where they're applicable, and including caveats under those ratings so policyholders know what's being rated. It's not this particular policy, but the strength of the company and its ability to carry out promises.

Are things hopeless? I don't think so. It's hopeless to predict long-term company behavior, but it's not hopeless to give the policyholder more useful information. First, we have to limit the information to that which the policyholder can understand, and not give him too much. Somewhat contrary to that, we do have to do sensitivity analysis so he can understand what the risks are. That's easy to do for an interest rate change, but what about dividend scales and policies that are more bundled?

How do you illustrate the mortality change and expense change and what's a significant variation in them? We should renounce attempts to do comparisons involving long-term predictions of company behavior that just can't happen. We should probably extend the smoothness test to current assumption illustrations. This would at least spread out nonguaranteed persistency bonuses. I don't think we should outlaw such things, but maybe we should outlaw the illustration of them.

While we are talking about disclosure, there is one cost that is known at issue to be a major item that varies significantly from product to product and from company to company. I don't think we've seen any proposals to disclose the compensation to the salesperson or acquisition costs generally. Perhaps this type of disclosure is something whose time has come. We haven't seen that in our industry yet.

Finally, we need to provide the agent the capability to do in-force illustrations. That way we can keep policyholders up to date, we can provide fair comparison when the policyholder is trying to decide whether to buy a new policy, and enable the agent to provide follow-up service to clients. This is an expensive service as we've all seen with in-force illustrations, but it is necessary if you want happy customers.

MS. FAUCETT: Is anyone familiar with the activities in Canada?

MR. CLIFF OLIVER: I happen to be a member of the Life Insurance Practice Committee which is undertaking a project to make recommendations with respect to sales illustrations. I should commence by stating that the problem is not as acute in Canada as it is in the U.S. It's a less-mature problem due to the time period that nonguaranteed type of policies have been sold on the market. Universal life really only took hold in Canada in 1987, and so we're looking at roughly six years of experience, but it's starting to heat up. We're following the same path as the U.S.

has come down. Nonguaranteed elements such as interest bonuses are starting to become very commonplace. Cost of insurance tends to be nonguaranteed in the U.S. whereas it's split 50/50 in Canada.

Interest rates certainly are not guaranteed. We have a lot of segregated fund universal life policies with no floor, so I was interested in your comments about showing guaranteed benefits. Since there are no guaranteed benefits in that case, it could not comply with that type of request.

In any event, where are we? We are working with various associations to coordinate out efforts. The ones involved are the Life Underwriters Association (LUA) representing all agents in Canada, the Canadian Life and Health Insurance Association (CLHIA), and the Canadian Institute of Actuaries (CIA).

The attempt is to reach a consensus whereby everybody can live with the guidelines. They're rather soft at this point compared to what you are proposing. We have an open forum right now in Canada. You can do nothing or you can comply with some existing guidelines that were put out by CLHIA many years ago, but they are voluntary guidelines. There's no requirement that you must conform.

An initial recommendation from our committee (which may change by the time it reaches final form) is to place the onus on the company and the agent to conform with certain requirements. The most important requirement deals with representations on the illustration, such as "this illustration is representative of current experience and is not guaranteed." There also must be a requirement by companies to show certain elements of the policy that are guaranteed such as the cost of insurance. This becomes difficult because other elements, such as interest, are not guaranteed. As I recall, our approach is to have a face page (similar to your face page proposal) which would summarize the policy values. The values shown would be those that are guaranteed in the policy in that section. Right below that would be the corresponding values that are being illustrated to show the differences. We have not resolved the problem of segregated fund policies where there is no guarantee.

That would start off the illustration package, and then below that would be the normal illustration, and below that would probably be another page with explanatory comments. The feeling is that a lot of consumers don't make it down to the third page so a summary is needed. To really get a message across the face page should show that there's a difference between contract guarantees and what the illustration is showing. Agent compliance is an issue with us because agents have the ability to run software from companies and illustrate things that are quite different from what was originally anticipated. To deal with this problem, there is a proposal for the agent's association to add to their code of conduct that agents must conform with certain guidelines regarding illustrations.

That's basically where we're at. It's very early, but I can see us coming along the same path.

MS. FAUCETT: I talked to Steve Prince a couple of months ago; he made a very interesting comment -- Canadians were focusing more on standards for the agent than looking at specific changes to regulation. This is a very different approach than we're taking in the U.S., so it will be interesting to see how it turns out.

MR. ROBERT B. LIKINS: I have a question that applies to Judy's, Bob's and Cliff's comments. A lot of the broader-based suggestions involve providing the consumer with additional information. Cliff and Bruce made the comment that we're giving too much information to consumers and they're being overloaded. Cliff said a lot of buyers and potential buyers don't make it down to the third page. How do we overcome this problem without suggesting the need for another regulation? In my company, illustrations go beyond three pages and I am concerned about the need for simplification. Bob suggested showing year-by-year values for the first 20 years, and then every five years after that. Maybe we should go year by year for five years and then every fifth year after that. What can you say about the simplification problem and the overabundance of information?

MS. FAUCETT: That has been an issue with which everyone has grappled. I've seen illustration packages that are over 20 pages; even our task force couldn't make it through the whole package, let alone the average consumer. One of the reasons I was particularly enthralled with the concept of the cover page is because I'm concerned that we already have too many numbers. More columns of numbers are not going to help the consumer. There also are a number of important notes that are probably getting buried; they are included in the summary pages, but the consumer wasn't getting to them because the illustration was so long. By having something right up front that very simply lays out some of the key points, the consumer has an opportunity to say, "These are the things that I'm particularly concerned about," or "These are the things that I'm relying on you to advise me about." I think that having a cover page goes a long way to the simplification.

Then we should get some focus on eliminating a lot of these numbers. I would agree with you that once you get out beyond the third year, the likelihood of any number actually occurring is equivalent to the chances of lightning landing on my microphone as I speak. The one thing that I really liked about the California regulation is its statement that the only thing we can say about these illustrated values is that they'll never happen. I thought that was a wonderful statement, not one that we want said quite that bluntly, but it was very true. If we can get away from having to show so much in the way of numbers and focus more on the concept, we can focus on what the need is, how this insurance is going to be used, and how it operates in that context. We've gone too far to making it look much more precise than it really is.

MR. NELSON: As I look back on the very sophisticated clients and the very simple purchasing consumer, I think that the agent holds the opportunity to do a lot to the illustration that we so diligently try to put in his hands. For example, we can unstaple the illustration and put the page of which you're so proud lower than page three. So when I thought of the discussions of the signature page, it seems to me that's the best page to show the simple sensitivity test, the very simple description, and maybe the admonition that the summary be illustrated. I'm not saying that we are trying to circumvent the system, but consider for a minute that I don't sell a considerable amount of insurance by saying, "Let me tell you all that's wrong with this product. In addition, let me clearly explain the risk that you are about to assume." So where in the ideal sales process does this get communicated? If we design systems to protect the consumer from the most creative agent, we will hamstring the rest of the industry. We don't need more data, we don't need more pages that are going to go unread; we need a simplification process. Consumers should not assume risks we haven't explained clearly in the past, and we should sensitize the customer to the probability of change.

I don't know where we tinker, but I do know that the consumer is not interested in a lecture on Insurance 101. There's a certain balance that we strike between relationship, trust, quality, and a product that consumers can understand. Then we go back and continue that relationship to help manage any change that has occurred. From an agent's perspective, that's what I believe is the right answer.

MR. HAROLD R. GREENLEE: I think if we don't produce material that the consumer wants to read and can understand, we are just wasting everybody's money and our time. As we focus on providing simple information up front, we must avoid requiring too much up-front information. For example, on policies with many premium changes, we can't show a complete premium schedule up front and hold the basic information needed to a single page.

In addition, we should look at sensitivity of our illustrations. There is general agreement that we need to provide better sensitivity information. I think there are ways we can do this. We can produce better sensitivity information by producing simple tables or simple graphs; there are several methods that could be used. We can produce just a few key policy durations based on different interest rates. In order not to give the impression that interest rates are the only driving force, for traditional policies we could base an illustration on a constant percentage of the current dividend scale. Some objections to this suggestion have been that such illustrated results will never happen. My rejoinder is that an interest rate scenario will never work out the way it is illustrated either. The difference is that everybody will perceive that the illustrated constant percentage results won't happen, but many may not perceive that the illustrated interest change results will not happen.

I also am a little concerned about the idea that there is one single illustration format that is going to work for all customers. There has to be a joint venture between companies and their representatives, and we must have faith that our representatives will provide appropriate information. Clearly, for an auto mechanic, the most useful information would be different from what would be most useful to an accountant or lawyer. The latter information will differ from what a broker working for a chief financial officer of a corporation will want to see. I am concerned about a possible expectation that there is one set of illustration rules that will fit everyone. I hope there will be a general understanding that the marketplace we serve is very diverse, and we should not attempt to serve everyone in the same way.

MR. NELSON: I think that the prudent person always acknowledges that there's going to be differences in everyone's attitudes and abilities. Some people respond to graphs and pictures better than they do narratives, and some people will never read narratives. My concern is that we need to sensitize the buyer to the fact that things can change. Then we have done the most that can be asked of us. We might do that in various formats, and maybe what works for each company will be different, but within the same framework of communication and simplified disclosure.

I failed to mention what impresses me the most. There are many companies who are not waiting for directives. We cannot submit a case to some companies unless we have a signed illustration. Is that good? I don't know, but it's one more attempt to try to solve part of the problem. There are companies that have changed their format for illustrations. There are companies that try to describe policies in English; rather than "enhanced Presidential limited special," they talk about the "term rider that reduces the premium required under current assumptions." I think that's a step forward.

I don't think we can wait until regulation demands it. I think that we must continue to let the market work. Some companies have already gone light year's ahead of where they were 18 months ago in their product descriptions on sales illustrations. I'm rather proud of some of these efforts.

I don't mean to present that it's hopeless from an agent's point of view. I wish we were selling eight to ten years ago what we're illustrating today at least as far as format goes. We would have been considerably further along the line in consumer understanding.

MS. FAUCETT: Within the various task forces and committees that are looking at this issue, there is a recognition that: not all products are sold by agents; whatever is devised must deal with a great diversity of distribution channels; and the needs of the person who buys a $10,000 policy is probably different than the needs of the person that buys a $10 million policy. In Bob's task force, there is a great diversity of agents in the markets they serve and how they sell. I think that having diversity certainly helps to keep us on track, but there is not going to be one answer that fits every situation. One of the things that we can do is come up with some changes that we'd like to see, and offer some ways that they can be done. There is no single way that will work for every kind of product or for every company or in every sales situation.

MR. JAMES F. REISKYTL: I've been involved with this IQ task force and we are involved with a few other efforts. I once thought that the answer was actuaries, and we ended up putting some questions in the annual statement. I should have known better. Good questions create clever answers. With that comment, how could we do a better job of answering the questions? I don't think the questions have changed, clever people just find ways to avoid disclosure. My personal view is you have to ask the customer what he or she wants." We often tell them what they want. As a customer and as an actuary, I'd like to know what I bought.

I think the regulators can actually do us a favor if we take advantage of this opportunity. We have a lot of numbers but we don't have the numbers we really need. And I suspect most actuaries would admit that if they had certain numbers, they could do a pretty good job of comparing companies. Frankly, the original IQ had a series of questions that said, for example, "if you weren't illustrating current expense or you were illustrating some projected changes, tell us the magnitude of the change." I don't think you have to give that answer to an agent or policyholder, but give it to the actuaries and they probably will be able to put together comparisons that will be useful for policyholders or agents. The IQ is an attempt to get experience differences. The obvious shortcoming is that agents ask me what it means. When projected mortality improves 10% a year, what does that mean to the buyer, what does that mean to my short pay period, what does it mean to my policy values or whatever it may be? So we have a lot of numbers, but I'm not sure we have really good numbers that help me decide which policy I should buy.

Bob, if I were coming to you to buy a policy, how would you tell me to compare whatever you're selling? You said you offered policies for three or four companies. How do you compare those policies and tell me which one I should buy?

MR. NELSON: "Inadequately" would be the short answer. The long answer would be that I have long believed there are a number of fine companies in this country, and that a consumer would be well served by a number of them. In each buying situation, the customer profile differs. Is that customer diabetic, is that customer young, is that customer a smoker or a nonsmoker? The reason we deal with more than one company is because most markets are not well served by a single company. So we try to have an idea of what the customer's trying to accomplish, and, as we develop that need, many risks could be placed with one of several different companies without ever having to compare it to another company. I believe that the accountants with their spreadsheets and the attorneys or financial advisors have done nothing to simplify our problems because they believe that things can be quantified. In fact, the variables go beyond actuarial tables -- whether the person's overweight, whether the person has a hobby or an occupation. All of these factors enter into whether the underwritten risk can be issued at what we're showing them. I'll also be responsible to the customer for the quality of companies that I represent and will watch their performance.

MR. BRADLEY E. BARKS: I wanted to echo some of Mr. Reiskytl's comments and make some additional comments on the direction we are moving toward.

I agree that there are currently lost of numbers in illustrations for comparison purposes and that we might not have the right ones yet. But even if the "ideal" numbers exist, I would submit that this is not the answer to the problem of illustrations.

Lee Dreyfus said in the general session that "communication is 90% reception and 10% transmission." I believe that this focuses on the true issues. It is probably true that most of the information needed is already in illustrations but doesn't get to the consumer because of their limited attention span or because of how the information is presented. Though it is usually not stated so simply, in the area of illustrations, format not content is the key to improving disclosure.

If it is recognized that the attention span of the consumer is an issue, then the logical answer is a summary of three pages or less that includes a mandatory signature page. Of course, additional information could be provided to recognize that different consumers have different needs but this approach would recognize the need for a "least common denominator."

A further benefit of this approach would be that the summary information would be in a common format. This might then be used for comparative purposes. The industry has long been searching for a single measure that could be used to compare different products. As actuaries we should recognize that when dealing with varying degrees of risk, no such single measure is possible. For this reason, I believe that the current cost disclosure indices and the yield index recently proposed by California should not be used. Because they don't provide enough information but are presented as a universal standard, they are misleading. Three pages of commonly available information would be much more valuable to the consumer and would not mislead them into thinking that comparisons of a single number were useful or valid. It would be easy for us as actuaries to succumb to consumers' desires for an easy answer, but our professionalism demands that we don't.

Finally, I believe that revisions to the Exhibit 8 Interrogatories are in order. They were a good first draft but given the data we now have on pat responses and the recent research into illustrations and disclosure, this area needs to be revisited. One thing that should be reconsidered is the purpose of the interrogatories. If they are truly intended to comment on the appropriateness of company illustrations, then we might serve our purpose better by requiring actuarial certification of the illustrations themselves rather than burying that opinion in the company's statutory annual statement.

MS. FAUCETT: I'd like to close with a professional challenge. You are the actuary who signs the annual statement interrogatories for your company or for one of your client firms if you're a consultant. You get a phone call from the ABCD saying that there has been a complaint registered about your responses to those interrogatories. How comfortable do you feel justifying your responses given what you know about your company's environment and how your products are being illustrated? I hope that you can all walk out of here with a big smile on your face knowing that that's going to be a very pleasant discussion.