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PROBLEMS AND SOLUTIONS FOR PRODUCT ILLUSTRATIONS

Moderator: BRADLEY E. BARKS
Panelists: GEORGE COLEMAN*
GARY E. CORBETT
ROBERT E. WILCOX
Recorder: BRADLEY E. BARKS

The NAIC is moving rapidly toward developing a model regulation for life insurance disclosure. That will be followed by a model regulation for annuity disclosure. This session will describe the approaches taken by the regulators and by industry advisory groups and will illustrate the issues involved. Attendees will be asked to discuss alternative solutions.

MR. BRADLEY E. BARKS: The subject we are going to talk about is life insurance and disclosure regulation, which the NAIC is working on currently. We are going to have a discussion among the panelists, and I hope that you also get involved. I would like to have this be as interactive as possible.

I am Brad Barks, chief product actuary for LifeUSA Insurance Company. On the panel we have Commissioner Bob Wilcox who has been with the Insurance Department of Utah since January 1993. He is the western zone chairperson in the NAIC and is the EX4 chairperson. He is also the health insurance risk-based capital (RBC) chairperson. Bob is a member of the executive committee of the NAIC and a number of other committees including the Life Health Actuarial Task Force and the Life Disclosure Working Group.

We also have Gary Corbett, vice chairperson of the Actuarial Standards Board (ASB) and former President of the Society of Actuaries. Gary is currently a consultant with Tillinghast in Seattle concentrating on demutualization of insurance companies. In his role as vice chairperson of the ASB, he is the most senior life person on the ASB, so he's been working very closely with this process.

We also have George Coleman, who is the chairperson of the Technical Resource Group (TRG), which is the industry advisory committee to the NAIC Disclosure Committee. He is vice president, government relations with Prudential Life Insurance Company. George is responsible for Prudential's NAIC activities with special emphasis on life insurance. George serves as a member of the American Council of Life Insurance (ACLI) Legislative Advisory Committee, and Accelerated Benefits Working Group, Marketing Practices Task Force and is a member of several other groups.

We have three of the top people involved in the area of developing the new model regulation on life insurance disclosure, one from industry, one from the ASB, and one from the regulatory community. They are in the process of working through many complex issues, and this may be one of the few chances any of us get to be educated on the issues and respond in person with solutions. The discussion will be

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*Mr. Coleman, not a member of the sponsoring organizations, is Vice President, Government Relations with Prudential Life Insurance Company in Newark, NJ.

separated into three main areas. First, we will be laying out the issues surrounding illustration and disclosure and defining the goals and objectives that will drive the process of reforming illustrations. Then we will describe the approaches that are currently on the table and how these came about. Finally, we will be looking at some sample illustrations to evaluate how well the various aspects of the current proposals fulfill the goals and objectives. I will be asking questions of the panelists and audience in order to guide the discussion through these areas.

To start off I'd like to come to some consensus on why we're trying to develop the new model regulation and what we want it to accomplish. The ACLI recently presented a paper to the NAIC containing some discussion points. I think the paper gives a starting point from which to discuss the issues:

> The American Council of Life Insurance commends the NAIC Life Disclosure Working Group for attempting to make life insurance illustrations more understandable for the consumer. We appreciate the effort and patience that the members of the working group have devoted to accomplishing this objective. We know this has not been a very easy task. You have diligently tried to address the interests of all parties, insurance buyers, regulators, insurers, agents, a difficult but necessary basis for action. This working group must ultimately develop a proposal which will require information that is understandable by consumers and that is enforceable by regulators. A life insurance policy is a long-term contract. It is, in some cases, a complex product that cannot be easily explained. This is why the consumer needs help to understand how the policy may work to meet his or her needs over the long-term period. An illustration that demonstrates the effects of both guaranteed and nonguaranteed elements upon the future values of the policy is essential for this purpose. Only with such information can the consumer make an informed purchase decision. Any proposal developed by this working group should require such information.

With that, I will ask George Coleman to give his views on why we are here, what we are doing with the illustrations, and a little bit about where the history has come from and what research has been done in the past.

MR. GEORGE COLEMAN: Obviously, this isn't the first time the industry and the regulators have become involved in disclosure and with illustrations. The NAIC models are replete with examples of actions taken to regulate the form of disclosures to consumers, the Model Disclosure Act, Life Disclosure Act, the Advertising Regulation, guidelines on marketing to seniors. There are guidelines on variable products that people aren't very familiar with, and any number of such proposals.

The engine for the current effort at the NAIC, which I was involved in from the start or almost from the start, were hearings conducted by Senator Metzenbaum in the fall of 1992. Those hearings focused on problems that were occasioned by the use of some abbreviated payment plans. The concern was that, with the declining interest rates, policies were failing to abbreviate or vanish, as some people call it. There was an expectation perhaps on the part of some consumers that they would vanish in all events at the end of six years or seven years or whatever, and that wasn't happening. Policies were not abbreviating or those that were abbreviated were again

requiring premiums. So, Commissioner Metzenbaum commenced hearings, and if you know anything about Congressional hearings, you know it gets the attention of insurance companies, and it gets the attention of state insurance regulators.

The NAIC formed a group to study and to prepare solutions on the subject, and the first hearing was held in November 1992 in Boston. At the following NAIC meeting in December, Judy Fawcett representing the American Academy of Actuaries (AAA), presented preliminary recommendations for improving life policy disclosure. I was named chairperson of an advisory committee, renamed Resource Committee, to work with the NAIC toward solutions to a very serious problem. Beginning with that meeting in December 1992, we commenced our own study. My Industry Resource Committee has some 30 members and includes the National Association of Life Underwriters (NALU) and Gary Corbett as ex-officio observer for the ASB. Our work began with a buy-in to certain of the recommendations of the AAA. In June 1993, we recommended an illustration explanation page, which was a cover to an illustration that would provide certain specific disclosures with respect to the contract applied for. This included basic information, such as "This is a life insurance policy," and proceeded to the much more involved areas of specific disclosures with respect to second-to-die, modular designs, and those policies that had abbreviated payment methodologies.

We worked over the summer to improve our proposal. In September 1993, we included our illustration cover-sheet sensitivity analysis and values at certain key durations (5, 10, and 20 years) on a guaranteed basis, a nonguaranteed basis, and at 1% below nonguaranteed as a sensitivity analysis. I'm not going to go into the details of our proposal because this is where Commissioner Wilcox comes in to tell you about the NAIC white paper that came out about that time.

MR. ROBERT E. WILCOX: First, let me explain that I came to this current process a little bit late. I was heavily involved in other things, like RBC for health plans. This past February 1994, Bob Wright, who is the chair of this working group, called me to help on the life disclosure working group. He said the group didn't have any actuaries on the working group, and it needed some additional expertise there. Since the NAIC has two commissioners who are life actuaries, they're trying to take advantage of that situation, so I agreed to help on the working group. When I attended the first meeting, I very much wanted to repent and take a different course. I sensed that, even though this was a problem that I had observed over a long period of time through my consulting practice, the regulators and the industry were reaching for answers in a very difficult circumstance. In that first meeting, I was hearing some things that I knew were very much fraught with problems. It was important to observe that these nonactuary regulators, experienced, competent people, were seeing a different set of problems than we, as actuaries, were used to focusing on. I'll try to help in the course of our discussion to bring that up from time to time. Their focus was emphasizing understandability much more than supportability. It is important to understand that we as actuaries focus on the supportability issue. What I was hearing almost exclusively was understandability.

The NAIC white paper was presented and reviewed at the September 1993 NAIC meeting. It identified some specific problems relative to life disclosure. First was the inappropriate use of illustrations to estimate future performance and to compare

performance of different companies. This is a very important part of this issue. Companies use illustrations in ways that are simply inappropriate. Other kinds of financial institutions are precluded from the sort of comparison that can be drastically altered by the assumptions that are used.

Second, it was observed that there was a real lack of accountability. In the current marketplace involving life insurance sales, there is virtually no accountability for any of the participants in the sale, not for the company, not for the agent, and interestingly, the white paper discussed accountability on the part of the purchaser as well. Accountability is a major issue. One of the things that we need to address as we develop a new regulation is the extent to which the company needs to be held more accountable for the actions of its agents. I think this is a fundamental issue.

Let's go back to the question of understandability. With no standardized format being utilized, many of the illustrations currently in use are far too complex for the average consumer or applicant to understand. In many cases the selling agent does not understand what he is presenting, and this needs to be addressed. There is a lack of standard and consistent definitions, which Gary will talk about. Even in the policy descriptions, policies are described with the particular nomenclature that the company suggests. This is not generic terminology so that, even if you're familiar with the business, you may not understand what you're being sold. You also may not understand the terms that may be used to describe the assumptions. This needs to be addressed.

There is never an adequate description of the policy. Consumers are not notified of changes, when those changes occur, after the original purchase. There are insufficient penalty provisions when there are abuses of the illustrations and a general feeling that the current regulatory approaches are out of date, considering the designs of the policies that are being sold in market. New products continue to evolve, and the regulations have not adequately addressed that evolution.

With regard to where we go from here, it's probably the appropriate point to bring up four alternatives that were in the white paper and that were extensively discussed by the industry following the release of the white paper. All four of these alternatives were presented by the NAIC as approaches to be looked at. The four alternatives were:

1. Use standardized assumptions similar to the practice that is being used in the U.K. where the government sets out the standards to be used in the illustrations. I think that this is an approach that needs to be explored in more detail.

2. Prohibit projections into the future, similar to the rules for mutual funds where all you can show is the past performance of your specific mutual fund. That's one of the alternatives being explored.

3. Require uniform illustration of format design and uniform definitions to eliminate some of the confusion.

4. Develop a set of rules that provide clear disclosure of the use of illustrations and the assumptions underlying the illustration.

In March 1994, I attended my first meeting of the working group. Its members voted to move in the direction of the second alternative, that is, to use illustrations showing guaranteed elements and showing past performance and nothing else. The reasoning was that illustration of past performance reflected the specific product being sold. This means that, if an insurance company came out with a new product design, it had all the past history of a brand new mutual fund, that is, none. The "A" Committee adopted that recommendation and passed along to the working group the assignment to develop a model statute that would incorporate this kind of an illustration standard. That really got people's attention. I believe that is what it was intended to do.

Before the last meeting of the working group, in May 1994, David Lyons, Chairperson of the "A" Committee, sent out a memorandum on the illustrations model that was intended to bring perspective back to this process. I would like to conclude this portion of my discussion by referring to that memorandum. It is in a question and answer form:

> Question #1: Has the committee taken the position that the illustration of nonguaranteed values for life insurance policies is inherently improper and, as such, should be banned?
>
> Answer: No, so long as the illustrations are clear and understandable and the benefit they represent to the consumer outweighs their potential for abuse. However, it has not appeared to the committee that a system has been devised that could assure this outcome. Therefore, restrictions appear in order.
>
> Question #2: It is rumored that the Life "A" Committee will only consider and will, in fact, adopt for exposure a model act prohibiting nonguaranteed illustrations, whether it has been adequately completed or not. Is that what the industry can expect in June?
>
> Answer: No. If the guaranteed-only model is not adequately developed or the members of the committee believe that there has been insufficient time for review and comment on that model, I could not expect adoption.
>
> Question #3: Given the present focus of the working group on guaranteed-only and the limited time before the June meeting, should industry experts cease work on materials and options relating to nonguaranteed illustrations prior to the June meeting?
>
> Answer: No. To the extent possible, the industry should both respond to the guaranteed-only draft and continue its work on nonguaranteed illustrations options.
>
> Question #4: Will the June meetings of the Life "A" Committee be limited to consideration and discussion of guaranteed-only options?
>
> Answer: No. The full range of issues and options regarding illustrations are anticipated for consideration and debate.

The working group does intend to complete a disclosure model regulation for discussion at the June 1994 meeting incorporating guaranteed elements with a past history. It is the expectation of the working group that this is not where it will end up. We will continue to make progress on other forms of illustration that will make sense. It is my hope that forums such as this, and particularly this forum, will provide additional input to the working group that will help us arrive at a satisfactory conclusion to this project. So, I would hope that you who are in attendance will take the opportunity to analyze the problem and provide additional input, not just here but as we go forward, and I would invite any of you who have additional input to provide it to the working group either through the chairperson of the working group, Bob Wright, or to me directly. I will see that it gets in front of the working group because we want the right answer. Your input is going to be critical in finding that right answer.

MR. BARKS: I have a question for you. Are there people on the committee that believe that guarantees only or historical past performance is the right answer?

MR. WILCOX: I think that the general conclusion is that this is an answer, not necessarily the best answer. I think people see some things better about that proposal than many of the other proposals that are being presented by the industry at this point. I think alternatives need to come with clear demonstrations that they provide a better alternative.

MR. BARKS: So the thing that the industry could take out of this is that the NAIC is moving in the direction of guaranteed only. There is certainly room to change that direction, but if the industry doesn't take some action and do something about it, we may end up in that position.

MR. WILCOX: Right now this is a back-up position with the working group. One of the other things that is important to understand is that the new standard nonforfeiture law for life insurance will include in it a great deal of disclosure information. It would be very embarrassing, at least unfortunate, if we ended up with a life disclosure model for sales purposes that prohibited things that the standard nonforfeiture law required. So it is my position that the standard nonforfeiture law ought to take precedence, and so I have tried to persuade the Life "A" Committee to at least develop these in tandem but giving precedence to the standard nonforfeiture law development. Then we will have a life disclosure model that will be consistent with and in some ways go beyond the standard nonforfeiture law but not conflicting with the standard nonforfeiture law. The new standard nonforfeiture law is currently on schedule for completion by the end of the year. I think that means that this life disclosure effort will not be completed before the end of 1995. The two projects at least have to move together, and I think that does give us some time to search for better answers, which is important to you.

MR. BARKS: I would like to go back just to summarize the objectives and goals of the regulatory group. Understandability was obviously the primary one. We also mentioned accountability for the company and also accountability for the consumer. What are some of the other ones that I missed just to summarize what you covered?

MR. WILCOX: The standardization of definitions and the manner of presentation. Those link with the understandability issue.

MR. BARKS: That is how we get understandability?

MR. WILCOX: That is a major part of how we get understandability. We have to get out of our mode of talking about these policies in language that can only be understood by the person who wrote the language. I find, after 30 years plus of experience in the life insurance business, that there is jargon used in illustrations that I don't understand. I can have difficulty in taking an illustration and figuring out what in the world the authors are trying to illustrate and how they are doing it. Imagine the position that "Joe Lunchbox" is in trying to take these illustrations and make sense out of them.

We need to get to some standardization in the illustration, the description of the policy, the explanation of how the policy works, and the assumptions that go into it. Finally, the other thing that I mentioned was the penalty situation. If an agent shows a history of misusing the illustrations, then drastic measures have to be taken, even if it means taking him out of the business and having him learn how to be a plumber or something else. If he cannot be trusted to use the illustrations that the companies provide for him in a straightforward manner that is not intended to mislead, then he needs to be in another line of business. Perhaps there need to be significant sanctions for the insurance company that appointed him and provided those illustrations, if the company does not control him well enough. I do not think at the present time that the companies are taking nearly enough responsibility for the actions of their agents.

MR. BARKS: As far as the last point there, is it fair to say that the regulation has to be enforceable both to the agent and to the company? The definitions and the regulation have to be specific enough that the regulators can enforce their application.

MR. WILCOX: It would be wonderful to be able to enforce regulations, but that is difficult. It has to have a good deal of specificity to it in order to point out the problems in application and make the regulation enforceable.

MS. CAROLYN J. EDDY: I am just wondering what your comment is on this. I believe that the ability to project reality may be falling through the cracks assuming that consumers can understand illustrations and that there were no gimmicks. If you are using just the guarantees, the ability to project reality kind of falls through the cracks.

MR. COLEMAN: That is a problem. Maybe we will be getting into the pros and cons of some of the different methods. However, one thing on understandability that frustrated me as I came in as an outsider to this process is that it is not the illustrations that are less understandable but the policies and the uses of the policies themselves are less understandable. That is really what the concern is. The draft NAIC regulation currently says that the illustration must be understandable by the prospective life insurance purchaser without the help of an agent or another life insurance knowledgeable person, or something like that. The way these products are used, whether it is key man coverage or so on, are not easy concepts. It is these concepts or the uses of the products and not the illustrations that are the difficulties here. I would hope we don't end up with something that would prevent the products from being used in ways that are good for consumers.

MR. WILCOX: I agree.

MR. BARKS: So, if I could paraphrase you, another objective or goal is to make sure that the illustrations provide the consumers with enough information so they can figure out how the product works. Understanding the illustration is fine, but it has to relate to how the product will function.

MR. COLEMAN: Yes, but I am not sure it is realistic to assume that can be done with paper only without the assistance of an agent or a knowledgeable person. I am sure you could write 50 pages and accomplish that, but nobody would read it. So, if you want something that is reasonably compact, and you have a very complex need that you are trying to meet, it may be necessary to supplement the illustration with some interpretation.

MR. WILCOX: I think that is true. I want to go back for just a moment to the question that was asked in terms of projecting reality. One of the things we have to get around on this is the fact that you cannot project reality. Reality exists when you get there. To try to predict in advance what reality will be is kidding ourselves. You can make projections based on any number of assumptions, based on what you are doing now, what you did in the past, and what you think you are going to do in the future, but you cannot project reality. That is a fundamental problem that we have to deal with and figure out how you come up with projections that have credibility. We need to give a reasonable picture of what might happen with the policy and not mislead someone into thinking that a projection is reality.

MR. MICHAEL J. ROSCOE: I just want to follow up on these thoughts. Just as an aside, I would say that about the only thing that I can say definitely will not happen is policy guarantees in all years. The question I have for you is regarding understandability and the two approaches that have been mentioned so far. The resource group's approach is an explanation page and some sensitivity analysis. The regulatory approach is to ignore all the flexibility within the contract and to ignore all the potentials of dividends or interest crediting. I do not understand how the second approach, which eliminates some of the features of the contract, gives you a more understandable approach than the first one. I wonder if you could summarize what the NAIC's position is in not following the approach of the resource group.

MR. WILCOX: I think if you listen to some of the people like Consumer's Union, they are saying that as an industry we are out of step with other financial services industries. I think there are some reasons to be out of step, but we have to make sure that there are some reasons for the way in which we are out of step. Although life insurance is not an investment contract, it can be compared to other investment contracts. Other investment contracts, for example, mutual funds, are prohibited from projecting results. They are able to show what they have done, but can never show what they expect to happen in the future. All other investment vehicles are subject to those kinds of constraints. I think that is where the thought process comes around to the idea that insurance products ought to be sold based on what you can guarantee and what has happened in the past. I still recognize that falls short of where we need to end up, but we still have to be reconciled to those perspectives.

MR. TIMOTHY BRUCHEDON: I had a question about allowing illustrations of past performance. A company looks at its past history and finds that there is certain past history that looks good and other past history that does not look so good. Surely, you would like to show your best. Would there be some regulation or standardization of that?

MR. WILCOX: There would have to be.

MR. SCOTT PATRICK ORR: When we talk about this we are considering disclosure and the problems of different futures. I think that perhaps we are losing some disclosure because currently an illustration may show the client a charge in seven or ten years, which may extend to 30 years. If we do not disclose this information in the future, then the consumer will not be aware of the charges. If we show just a guarantee, we are not really showing the product we are selling. We are selling them more than that. I think we are going to lose something if we don't disclose the future charges in some sort of way.

MR. WILCOX: I understand.

MR. BARKS: I have heard a comment from the panel that there may be some misunderstanding about where the industry and regulatory proposals are actually at. I would like to ask George or Bob to comment on some of the misconceptions that are out there.

MR. COLEMAN: Well, I think Commissioner Wilcox suggested that perhaps the NAIC is not going to end up with its current proposal, which is a mixture of guarantees and some measure of past performance. The industry has verbally pointed out some problems with that approach and will shortly be addressing it in writing. Primarily, you cannot get at those numbers very readily. Once you get them, they are not any more meaningful than current scale, so why go through the exercise? You still have to produce an understandable illustration, and it is certainly not more credible to show past performance, which is higher than current scale right now. That is a little bit of a snapshot of our position on past performance, and the regulators know that. I am encouraged to hear that the book is not closed and minds are not closed. Certainly our minds are not closed in the industry either.

MR. WILCOX: I think that it is important to understand that we are anxious to look at alternatives. I think the industry also needs to understand that the "A" Committee expects to have waiting on the shelf a model that is guarantees and past performance only. If we reach an impasse in trying to come up with an acceptable alternative, there will be a model on the shelf to be implemented. That is a mighty big hammer as far as I am concerned.

MS. MING H. STANTON: Commissioner Wilcox was talking about comparing an illustration with a mutual fund. I think there is a basic difference between buying mutual funds and buying insurance. Buying insurance is a long-term commitment for both the insurance company and the insured. Sometimes the insured may worry about the long-term premium paying commitment. I think agents frequently use vanishing premium to assure consumers that the dividend can reduce the long-term

commitment. In contrast, mutual funds have no commitment for long-term payment of the deposits.

We do not find that the policyholders are complaining about the nonguarantee features because they readily admit that they knew they were not guaranteed. They are not saying that a company is doing something improper. However, I think there are two problems here. We frequently hear the policyholders say that the company did not warn them that the premium would not vanish, which I think Commissioner Wilcox addressed. The second thing we are really wrestling with is when the company should stop illustrating on current dividend scale. Many times a company will have some idea that dividends will reduce as much as a year before the actual dividend scale is approved by its board. A company may still be illustrating the policy based on the dividend scale it knows will not be supportable. Now, does this constitute misrepresentation? That is a very tough question. So, when should the company really stop illustrating with a scale of dividend that it no longer can support?

MR. WILCOX: I think it is time, Gary, for you to step in on that one.

MR. GARY E. CORBETT: I would probably step in by doing a side step toward what I was going to talk about. I think right now the only answer to that is that the only thing that companies are permitted to illustrate is current scale. I know exactly what you are saying. When I was the chief actuary of a large New York company, I was concerned about this because we had the period of new money rates going down. You know your portfolio rate is going down. You know dividends are going to go down. But if you start doing something else, how do you describe it? You do not necessarily know what your new scale is. You know that the old one is going to go down. So, what's the alternative? Obviously, you would not want companies to start illustrating an increase in scale when you have the opposite situation and investment rates are moving up. I do not think it is an entirely good situation, but as long as what is permitted to be illustrated is current scale, I think it is your scale until such time as the board changes it. George, you're the attorney here.

MR. COLEMAN: I agree.

MS. STANTON: I think some of the companies even illustrate old rates after the board approves its new dividend scale because there is a couple-month lag between the board's approval and the effective date of the scale. We find some companies may even illustrate old rates after the effective date. Their excuse is that they could not get the information to the agents. All these are the problems, and the consumers are very frustrated by them. I think the industry probably should address that.

MR. BARKS: This issue and the other comments about reality are both related to consumer expectations. The vanishing premium is also related to policyholder expectations. I would like to ask the panel, if we are trying to make sure that the illustration has a high likelihood of meeting policyholder expectations? Is this a goal of this process?

MR. WILCOX: I think it is. If we are going to have a group of consumers of our products who are satisfied with what they get, we have to meet their expectations. Obviously, there are two adjustment points whereby that can be accomplished. One

is that you can change the outcome to match the expectations. The other is to change the expectation to match the outcome. I think that too many companies have been focusing on putting out expectations that will give them a market share that will make it possible for them to survive or thrive in the future. They worry about meeting those expectations when they have to, but that really does not serve our industry very well. That is why we have a number of advocates out there proposing different positions than the ones that industry is advocating. Let me quote one sentence from the National Insurance Consumer Organization addressed to the working group in October 1993, "We strongly urge the NAIC to prohibit future projections and work on developing ways to provide standard formats or requirements for providing information about historical performance such as the Best dividend studies." So, you have consumer organizations out there that are saying that the current track that the working group is on, the one that probably almost everyone at this session would oppose, is the right one. There may be some people who are here that think we ought to go back. Is Jim Hunt here by any chance?

MR. BARKS: I invited him. He could not come.

MR. WILCOX: I wish he was because he is one of the signatories of that particular letter. It may be an appropriate time to open up some discussion on an issue, and this is one where I would like it to be a two-way discussion. In the original four alternatives that were in the NAIC white paper, the first alternative was the use of standardized assumptions, and virtually everyone from the industry came back and said, no, no, we can't do that. Let me try to point out the flaw in that thinking and see if maybe we can revisit that and determine if there isn't something there that we ought to look at more closely. One of the first responses that came in on the NAIC white paper was from NALU:

> Life insurance has been sold for many years with the aid of sales illustrations that were formerly called ledger statements. The sales illustration as a tool needs reform to more accurately convey how a policy might work. NALU wants to strongly state at the outset that it does not condone the use of sales illustrations by themselves to compare one policy to another. They are simply inadequate to accomplish that task, but sales illustrations can accomplish the useful task of illustrating to the consumer how a policy works.

The NALU took the position that the sales illustrations should not be used to compare one company's policy with another company's policy, but then when it came to standardized assumptions, the NALU said, "NALU opposes standardized assumptions because they can make good companies look bad and bad companies look good." I think that you are really talking out of both sides of your mouth when you say that the illustrations should be used to show how a policy works, and they are not good for comparing one policy to another, but then worry about how standardized assumptions may distort the comparison.

I think that the nature of the management of an insurance company can change. A company can be sold. The brains that were behind the company may all retire and be replaced with new people who are bright but incompetent. All sorts of scenarios can change. What happens with standardized assumptions if you take the kind of approach that was used in the U.K. where there is a very low assumption and a very

high assumption? While these are intended to be extremes, companies can do that badly, and they can do that well. It shows to a policyholder how a policy is going to work, and it shows in the extremes how it might work. Why isn't that a good way to illustrate a policy?

Now, let the company, in addition to that, tout its historical performance. Let the company show how well it has done in the past, and talk about how good its management is and how expert its investment advisors are. Why not have a leveling of the playing field relative to the illustrations by using standardized assumptions? We can discuss whether we standardize just the interest rates and not standardize the other assumptions. I am interested in some response from you realistically about what is wrong with standardized assumptions. They will accomplish most of the things that we are trying to accomplish here. You can still illustrate the complicated policies, but you do it with the same assumptions that other companies use. Of course, you would illustrate your guaranteed values in addition. I am interested in some feedback.

MR. COLEMAN: Well, let me start because we started with you on this before. Our fundamental disagreement with this approach is that, while it serves to show how a policy would work under one or more scenarios, it is entirely unrelated to the insurer's performance.

MR. WILCOX: But so is current performance, George.

MR. COLEMAN: Notwithstanding what the NALU might say, I think it is also important that, in addition, to showing how the policy "works," we show some potential. Otherwise, if you can't show any distinction among companies, then the good companies are going to be just leveled with the poorer and vice-versa. Standardization would be anticompetitive in that regard, and although we certainly don't guarantee the current scale, it is a factor people ought to be able to take into consideration and with the proper disclaimers. People ought to be able to look at and see a value out at the end of the road, or whenever they are going to need those values. They want to know what premium commitment they are going to have to make. We think this is legitimate. If you show a standardized assumption of 12% interest, what is going to stop an agent from saying that is the one the policyholder is going to get? So we really do not like standardized assumptions. I understand in Great Britain the industry has had problems with standardized assumptions and has recently required companies to use their own expense assumptions because there was some finagling with the scheme of illustrations over there.

MR. BARKS: George, it sounds like you are referring to expectations. I think what we measure against are these goals we are discussing.

MR. JAMES J. REILLY: I do not think standardization is a bad idea. However, if you require companies to illustrate 8% interest, a company developing a universal life (UL) product could have a 400 basis point spread and have no other loads because it knows it is going to illustrate 8%. When it comes to actually issuing the policy it is going to be at a 5% rate. Being able to illustrate at 8% gave the company a big advantage because it was able to put all the loads in the spread.

Another big problem seems to be the vanishing premium illustration. When a company illustrates that a policy will have premiums that vanish at year six or seven, there is no guarantee that they will really vanish at year six or seven. I do not think the policyholder should just find out in year eight that he cannot vanish in year eight. I think if our experience gets worse than what we illustrate, we have an obligation as a company to disclose that. We could put a notice on the bills that says experience has gotten worse than what we illustrated and show the policyholders an in-force illustration. So, if a company wants to illustrate 12%, fine, but three months later the company is going to have to put something in bold letters on the bill saying, look, it is no longer 12%, it is actually 6%.

MR. COLEMAN: We agree with that. It is part of the industry's recommendations that there be that kind of information provided.

MR. PAUL MARGUS: Just pursuing the same point. You need only recall the single premium life of a couple of years ago, which had zero cost of insurance and attempted to do everything through the interest spread. Some companies would like nothing better than to illustrate according to a standard rate there. They would look awfully good.

MR. WILCOX: Would they look that good with two steps of assumptions, a high and a low? In today's environment, in addition to guarantees, you required them to illustrate at a 5% interest rate and an 8%, 9%, or 10% interest rate? What would they produce at 5%?

MR. MARGUS: The problem is that it is the same interest rate that the policies with cost of insurance rates are using, and so a policy with zero cost of insurance is always going to look better at the same interest rate.

MR. WILCOX: No, you would also have a standardized mortality charge and a standardized interest charge to go with that.

MR. MARGUS: There are similar problems under current designs. It is very customary not to be charging mortality rates. Even when mortality charges are not explicit, we charge cost of insurance rates, which are often not select and ultimate. Unless there is some effort also to standardize design, I do not see how it is going to work.

MR. CORBETT: I have been concerned about that because I have a certain sympathy for standardized assumptions. I see how it works better where you have a component-type product, e.g., UL, where you could have standard interest rate, expense, and mortality charges. I find it much more difficult for traditional participating business with different levels of gross premium and three-factor formulas. It may be workable there, but I think it does not work as well as where you have those separately identified charges like you do in a UL-type product.

MR. WILCOX: You could take those standardized assumptions and plug them into a dividend formula and produce a hypothetical set of dividends.

MR. CORBETT: Yes.

MR. WILCOX: Or two hypothetical sets of dividends, the high and the low, and then show the performance of the policy on that basis, and I think that companies have the capability of producing these types of illustrations.

MR. CORBETT: It does certainly get more complex. It is not as easily understandable by the insured when it is all hidden in a three-factor formula. I think the consumer needs to know more than what he will ever know to understand what is going on when you apply consistent assumptions to a traditional participating policy.

MR. WILCOX: Do you think that we could take those standardized assumptions and with appropriate actuarial standards make sure that those assumptions were consistently applied in developing hypothetical dividend scales to be used for illustrations?

MR. CORBETT: Yes, I think that is very possible. I said I did not think it would be very understandable, as to what was going on, by the consumers.

MR. WILCOX: But is it any less understandable than what they are getting now?

MR. CORBETT: Perhaps, but certainly no more understandable.

MR. JAMES E. SCHEID: I see a basic problem with standardized assumptions. A company that operates efficiently in its administration and distribution of business or pays lower compensation to agents should be able to operate with a lower interest lift-off and a lower cost of insurance. If standardized assumptions were mandated for all illustrations, a company would not be able to take credit for the efficiency with which it operates.

MR. WILCOX: Could you counter that with allowing the company to also illustrate how its past performance compared with the standards in the past so that you do not lose that? It is important for a company that has operated well to be able to show that it has operated well, even though it may be no indicator of how well it is going to operate in the future.

MR. SCHEID: You have to get the consumer to read the fine print beyond that, and I do not think that is going to be viable in most instances.

MR. BARKS: I think one thing that we have been talking around that maybe we should get out on the table is comparison of policies. It has been said by some people that illustrations should not be used for comparisons. I think some of those people have realized that this is a very difficult position to defend because illustrations will be used for comparisons. However, it may be necessary to have additional information with the illustration in order for it to be used for comparisons. So, if we decide that they are appropriate to use for comparisons, then some of the desire for standardized assumptions may go away.

MR. WILCOX: I think that's true if you are going to use them for comparison purposes, but the consensus has been stated that they ought not to be used for comparisons. The basic argument for using them for comparisons is that, if you provide them, that is what they're going to be used for. I think that standardized assumptions is probably the best answer to prevent them from being used for that. It

allows you to step around the issue that, if you provide illustrations, they will be used for comparative purposes.

MR. BARKS: But, the assumption behind that is that we do not want to use them for comparative purposes. The question I am asking is, is that a good assumption? Do we really want to do that? It sounds like the consumer groups are really saying, yes, we want to use these for comparative purposes. It sounds like the industry wants them for comparative purposes, also.

MR. WILCOX: No, I think the consumer groups are saying we do not want illustrations of the future because that is what they are going to be used for.

MR. COLEMAN: I think maybe it is more that they are afraid that the nonguaranteed elements will not realize the potential that they are suggesting in the illustrations. I think what we are getting at here is the credibility of illustrations. There are other ways to approach the problem such as the method we are using with some minor changes rather than going to something as radical as standardized assumptions for our industry. If you do not believe the numbers the companies are illustrating, then we should attack that issue. I think we have in our proposal.

MR. WILCOX: I think that is a valid issue, and I would like to hear some from Gary on that, but I would say that, if companies had not abused the supportability in terms of their illustrations, we probably would not be here talking about this. If companies had uniformly performed responsibly in terms of illustrating the actual real scale and not trying to work it around to illustrating something that was inappropriate, we would not have this problem.

MR. COLEMAN: Well, I would not diminish the problems there are with misrepresentations in the marketplace, but I think we all have to acknowledge that one of the major problems has been the decline in interest rates. Our problem is as much an interest rate problem as it is a marketing problem.

MR. CORBETT: And I think it is worth pointing out that we would have this problem of expectations not being met under almost any system that is being proposed, except guarantees only. If we had been using historical, we would have had that problem. If we had been using the old current scale or if we had been using some of the proposals of the industry group, we would have had that problem. The main problem has been falling interest rates, and it has caused premiums not to vanish. It has caused benefits to be less, and the only thing that could have solved that would have been guarantees. That would have solved it two ways. First, there would not have been illustration. Second, there would not be any product sold.

MR. BARKS: Someone pointed out that, if you illustrate guarantees only, the agents will make up their own numbers, which could even be worse.

MR. GARY W. HIRSCHKRON: First, I do not know of any realistic way that products can be compared without illustrations. Second, I agree that we should be using standardized assumptions for gross interest rates. I think that is a good idea. If you look at the world of variable life, that has basically been promulgated for a number of years, and it is working. The problem with traditional products is that they have a

black box approach, especially participating products. This approach really is not appropriate for or comparable to other financial products that people are buying in this day and age. I think buyers need to be able to have a way to see some relationship between an earnings rate and what they are actually getting on the bottom line. If dictating a gross earnings rate for the assumptions would get that for buyers, it would be a real service. I think that the dividend formula in a product is a black box to hide behind that nobody else has in any other kind of financial product.

On the mortality side, I really do not see a way of getting around going with current rates or something like current rates as long as we are living in a world where there is such a huge gap between current and guaranteed. And where there is a large difference between different companies and how much they are charging for mortality.

MR. BARKS: Gary, how would you respond to the person from the New York Insurance Department who said that life insurance policies are fundamentally different than mutual funds in that they have a long-term relationship and, therefore, they have a base of underlying assets that presumably are not going to be traded periodically.

MR. HIRSCHKRON: It is a portfolio of fixed-income assets that is being turned over every five or ten years for many decades. Presumably different companies that are all being fairly well-managed will be able to earn similar gross rates of return over that period. For different companies to be able to subsidize those for periods of time and not even allow consumers, even the most educated consumer, to have any way of picking out how much of that is really supportable, how it corresponds to any kind of gross earnings or market rate makes it difficult for buyers.

MR. WILCOX: I would not suggest that the use of standardized assumptions avoids some of the difficult actuarial standard problems that are there because of this dividend black box. We need to make sure that, if you standardize the gross rate of return, that the company does not distort the outcome by shifting it from the interest rate margin into the mortality charge. If you develop appropriate standards, then I think you can overcome those problems, but the real advantage is that you put everyone on an equal footing in terms of assuming the same gross rate of return. That is the big advantage, the others are secondary to that.

MR. BARKS: I want to go back a little bit and give George a chance to respond to or add to our list of goals and objectives. I added flexibility and consistency. I know the industry has been wanting flexibility so that companies can customize illustrations, but there may be some other things that need to be added.

MR. COLEMAN: What I do not like is "high likelihood of meeting policyholders' expectations." I think when we are talking about that, we are really talking about moving to guarantees and with all the problems attendant thereon. The 44% of the values and benefits paid by Prudential in 1993 were nonguaranteed elements. That is an important aspect of our sales. If we are trying to meet expectations, then I think we have a major problem. If we are selling on the basis that this is going to fulfill your expectations without the disclaimers that are necessary, then we have some major problems.

MR. WILCOX: Don't you think that, if you are not trying to meet the policyholders' expectations, you better make a sincere effort to adjust their expectations? That is what disclaimers do.

MR. COLEMAN: We do that with a sensitivity analysis. Certainly people want to have some reasonable idea of the kind of premium outlay they are going to require in order to produce a certain result, and then they will see the reduced values with a reduction of 1% on the interest rate factor. So they will have some idea of how the policy is impacted. Of course, we are open to all kinds of suggestions as to how that sensitivity analysis should be worked in but high likelihood is something that triggers a reaction from me.

MR. BARKS: Is credibility a better word?

MR. COLEMAN: Yes, credibility in the sense that those numbers were developed using actuarially appropriate standards.

MR. WILCOX: If the policyholders' expectations are built around the concept that they are going to get a fair dividend, and that fair dividend means that, if the interest rate goes up, policyholders get more, and if rates go down, they get less, and if that is their expectation, there should be a high likelihood we will be able to meet it. I think we need to adjust their expectations so that their expectations are something that we can meet. If we say we are not going to have a high likelihood of meeting policyholder expectations, then we are promising the wrong things. I am using promising in the broader sense now rather than the specific guaranteed sense.

MR. COLEMAN: To the extent that standards can address that, then I think we are pointing in the right direction. I think with appropriate standards we can assure that a lot of the puff is taken out of some of these illustrations.

MR. FRANCIS C. BERNARDI: A concern I have about illustrating guaranteed only is the potential pressure that can be put on companies to strengthen their guarantees. There was a recent article in the *National Underwriter* and a quote in it regarding the benefit guarantee associations. The quote said that a few years ago Executive Life had the best guarantees in the business.

MR. JAMES N. VAN ELSEN: I have a concern that we are not taking into account just how our consumers in the future are going to be able to use these illustrations. Bear in mind we are in an environment where consumers are used to selecting between several hundred mutual funds for investing their money. Consumers need a way to select one company over another. I am concerned about some of the proposals and the effect they will have on the marketplace. If you go to guaranteed only, how will companies compete? They will compete either, as the last gentleman said, by increasing their guarantees, which may be inappropriate, or increasing agent's compensation. You would essentially be creating a credit-life-type marketplace. Companies will compete. If you go to an approach that is based on past company experience, the larger companies will be in a much better position to be able to demonstrate that. The smaller companies do not have the "experience" to be able to justify that. Industry experience notwithstanding, that does not make up some of that gap. It strikes me that a good approach might be one that is somewhat based

on a current scale, subject to some reasonableness standards. There are clearly some assumptions that are unreasonable. Some of the bigger mutuals ought to be able to show the benefit of some of their lower expense ratios, but, on the other hand, tougher underwriting standards by other companies ought to be able to be reflected in the illustrations. I do not know how you can do that with standardized assumptions.

MR. BRYN T. DOUDS: I really just want to echo these comments about the realities of the marketplace. We are not operating in a vacuum here. The National Association of Securities Dealers (NASD) says that projections can be done at 0%, 6%, and 12% yields. If you go with guarantees, then you have, in essence, said, let's quit selling products with low guarantees. This may push the industry toward variable products, which may or may not be good for the customer.

With regard to standardized guarantees with participating whole life, I think anybody who has done pricing of participating business knows that, even given a complete set of assumptions, it is still possible to come up with a nearly infinite variety of dividend scales. So, I think we have a lot of problems with that idea.

THE ASB's ROLE IN DISCLOSURE REGULATION

MR. BARKS: Now, I want to give Gary a chance to talk about some of the different proposals.

MR. CORBETT: I would like to talk about two separate things, actually. First, I am going to put on my ASB hat and talk about the role of the ASB and why we are involved here. Then, I want to talk a little more about some of the specific proposals, although a lot of this has already been touched upon.

First, with my ASB hat on I think it is reasonable to ask, Why is the ASB involved here at all? Why should we be looking to actuarial standards of practice rather than laying everything down in law and regulation that would govern this? I think the reasons for it are really almost identical to those that gave rise to the development of the appointed actuary. Products are so complex and products change so rapidly in the future that there is no way you can write a regulation that can possibly handle all the situations that are out there in the marketplace. Also, regulations by their very nature have to be very specific and really can provide no room for actuarial judgment. There are two reasons why standards of practice would be of tremendous value: (1) they can be more responsive to change, and (2) they can properly proscribe the boundaries around actuarial judgment to come up with some reasonable answers.

As I have emphasized to the NAIC and the working group, I do not believe it is the role of the ASB to say what should be illustrated. We feel we need to participate in the drafting of any regulations if the NAIC and the working group are going to call upon an actuarial standard of practice because the regulation could be worded in such a way that it could make it very difficult for us to develop a standard of practice to support it. With regard to whether it is guarantees only, current scale, historical or recent historical experience, or standardized assumptions, the ASB will take no position on that.

The AAA acts as the spokesperson for the profession. It will be responding to the working group, which is really an update of the original work done by the Judy

Fawcett task force that started out as a Society committee and then became an Academy task force. The AAA will be looking at the criteria and analyzing each of the proposals as to how well they meet each of these criteria. I expect that report will be out in the very near future.

I think it is important to talk just briefly about the process the ASB goes through in developing a standard because there has been some concern on the regulators' part that we can't develop a standard fast enough for them to implement a regulation. I had told the NAIC in early March 1994, in Denver, that if we had a draft standard by mid-March, which is long past by now, we had a very good shot at having a standard in effect that could have been adopted by the ASB in October 1994 and in effect for January 1995. I still think that sort of one-year time frame is a very practical one, but we do need something to start with. Right now the proposals are really quite different, and we do not feel we can start writing a standard on behalf of the NAIC when the NAIC hasn't expressed any acceptance of the concepts there. However, we are going to initiate some meetings with the NAIC working group and try to give its members a better idea. If they suggest two or three ways the regulation might go, we can give them some idea of what might be in a standard, what sort of teeth might be in it to support those regulations. One thing I should mention is we always have the possibility of writing what are called actuarial compliance guidelines, too. They do not have to be actuarial standards of practice that conform in all respects with actuarial principles. We do have the compliance guideline route.

We do have a couple of standards that touch on this problem now. Actuarial Standard of Practice No. 1 addresses the nonguaranteed policies, excluding dividend-paying policies, but it really says nothing about policy illustrations. It is primarily a disclosure document. However, Actuarial Standard of Practice No. 15, which covers dividend determination in the participating area, does have some things in on illustrated dividends. I am sure all of you who are with mutual companies are aware of this. It says the actuary's primary responsibility with regard to illustrated dividends is to ensure that dividends appropriately reflect the current financial results of the company and are related to paid dividends in an equitable, justifiable manner. It also covers other areas. There has been some suggestion that all we have to do is rewrite and refine Actuarial Standard of Practice No. 15 to conform with whatever regulation comes out and add comparable language to Actuarial Standard of Practice No. 1, which is for nonguaranteed elements in nonparticipating policies. We have not felt that this is the way to go. If we end up writing a standard here, which we certainly expect to, it would probably be one standard for the one regulation that would apply equally to policies with nonguaranteed elements and dividend-paying policies.

The only other thing I wanted to say on the ASB side is, what can the actuary certify to? We are not really comfortable with some of the language that is in the drafts. We feel that the only thing a qualified illustrations actuary can attest to is that the scale being used for illustrations was developed in accordance with the regulation and with applicable Actuarial Standards of Practice. We do not feel it is the actuary's job to sign off on each and every illustration even if it is a stamp of some sort. It is the underlying scale that enters into the illustrations that an actuary can certify to. Also, the actuarial profession in its disciplinary process in no way can control the actual use of illustrations. That is something that has to be done through regulation in the legal process. We cannot prevent companies or agents from misusing the work of the

actuaries. Finally, all of the current regulations call for the appointment of a qualified actuary, which would indicate a single qualified actuary. We feel there should be no need for a company to have to designate one single qualified actuary. In some of the large companies, for instance, traditional participating products might be handled in a completely different department and by different actuaries than the UL-type products. Formerly, those would be written in stock subsidiaries, but now I think in virtually every state mutual companies can write these products in the mutual company itself. I think that this is a minor point, but it is not something we have had a lot of discussion on.

If there are any questions about the standard-setting process or that role itself, I would be happy to answer some questions there before moving on.

MR. WILCOX: I have just one comment relative to the qualified actuary. It has been suggested by some that the results that go into the illustrations are so integrally linked with the overall financial performance of the company that it really ought to be the appointed actuary who is making that certification. At some point we need to discuss whether or not there is any validity to that.

MR. CORBETT: I had not heard that. Again, large companies are quite different organizations, and it can be difficult.

MR. WILCOX: I understand that.

MS. STANTON: Gary just said something that disturbs me. He said that the actuaries are not responsible for the misuse by the agents of the actuarial scale. The problem here is that we said the agents will say anything to sell a policy. Right now we are considering holding the company responsible for all the illustrations. Either the actuary, lawyer, or someone else needs to be responsible for those illustrations. What disturbed me is that, if someone has to be responsible, since the actuary knows the dividend scales and the products, why not the actuary?

MR. CORBETT: Because the actuary cannot control the use of the illustrations in the marketplace. The actuary, if he is a senior officer of the company might be held responsible. I am not saying the company should not be held responsible and even the officers of the company, I do not think the actuary in his role as the qualified actuary or the illustrations actuary can police how this is used in the marketplace.

MR. COLEMAN: I do not think there is an insurance department in the country that does not have the authority now to punish companies and agents for using illustrations that are misrepresentations or that violate the law.

MS. STANTON: We seem to be talking about two different things. One is where we were saying the company is responsible for the illustration and the contents of illustrations. The other is where the agent actually twisted the contents. I don't know what you mean by misuse by the agent. So, maybe that is the problem. If the content is correct, either the policyholder misunderstood or the agent just twists it.

MR. CORBETT: I think there certainly have been clear cases. With PCs available like they are, anybody in the marketplace can produce their own illustrations.

MS. STANTON: That is a different illustration.

MR. CORBETT: It may well be.

MS. STANTON: That is why we in New York are thinking that the company should standardize its illustrations so the agents cannot make the illustration on their own. We do have a problem with talking with special agents. They really use a different kind of illustration. Even the company has it standardized. But we are thinking special agents could pass their illustrations through the company before they can use them.

MR. COLEMAN: We certainly contemplate that agents could only use illustrations, the format of which had been blessed by the company. Neither companies nor agents could use illustrations that use assumptions more favorable than ones that have been approved by the company actuary in accordance with standards to be set by the ASB. So, every which way we get back to the company liability for the actions of the agents in the course of their authority. I do not see any overriding problem with enforcing the law and the unfair trade practices law against agents and companies. Maybe they need to be tightened up. Maybe the authority is spread among a variety of regulations, but I think it is there.

MS. STANTON: I would like to go back and talk about standardized assumptions. I thought currently the only standardization is in the interest rate, but Commissioner Wilcox was talking about mortality, and maybe expense charges. The more you standardize, the more confusion it causes. A consumer could get a quote of gross premium from two companies, which are identical, and he was told that the company uses standardized assumptions, such as interest, mortality expenses. Yet, the result can be quite different because one company could compute dividends on the reserves and the other company could compute dividends on the dividend fund. There are different methods and results, yet consumers, will not understand any of this. Therefore, I think it would cause more confusion than it would eliminate.

MR. COLEMAN: I can quickly go through the industry proposal because it does treat the two aspects that Commissioner Wilcox spoke of. Those are understandability and supportability aspects, but I will emphasize the understandability aspect of it because Gary is the expert on the supportability aspect of it.

We made a proposal on January 31, 1994, which incorporated a lot of our earlier ideas, including the illustration explanation page to the NAIC. Our illustration explanation page provided key information on the policy: premium requirements and special features such as abbreviated methodology, the modular concept, second-to-die, two benefit streams, and so on. We provided within the explanation page values at three specific durations: 5, 10, and 20 years on the guaranteed scale, the nonguaranteed current scale, and 1% below the current scale, as a sensitivity analysis. There was a signature requirement whereby the agent and the policyholder would attest to delivery of the page and the fact that there were guaranteed and nonguaranteed elements in the policy. This would be delivered by the agent. If it was direct mail, there would

not be a requirement that agents sign it. Companies would maintain a copy of this explanation page with the file. If a policy was issued other than as applied for, for instance, there is a rating applied or other substantial change, then a new explanation page would be delivered by the agent with the policy.

Our proposal contemplates policy updates. A policyholder would be notified of adverse changes in crediting rates on or before the policy anniversary next following an adverse change in the scale. The notice tells the policyholder how to obtain more information on the effect of the change. Many companies already do this, especially in the abbreviated markets. Upon request you would provide to the policyholder an updated policy explanation page again showing the values, with actual policy values up to the current date, and then the illustration projected forward based on current scale. Insurers could, alternatively, satisfy this requirement with an updated policy illustration. Gary will talk about the actuarial standards we contemplated within our proposal.

In our most recent proposal, we incorporated illustration format recommendations. We were kind of late coming to this conclusion, but we had hoped to provide a lot of meaningful information in the policy explanation page, and we think we do. I think it is probably as important as any other aspect of our proposal, but the thought was that we did not want to take away the flexibility of companies to have their own particular format of illustration. At the same time we recognized there was certain key information that ought to be mandated and in certain cases, presentation should be mandated. So, we are not requiring slavish adherence to a rigid formula. However, we have established a number of standards. One was to prominently identify the contract as life insurance. It sounds kind of basic, but we keep hearing and reading how this is not always understood, and we will take those people at their word.

We also decided that we should require common headings. We have dubbed them premium outlay and the amount anticipated to be paid by the consumer out of pocket, which might be different than the contract premium. That is the amount that the contract requires to continue the policy in force. You would have to show the rating classes, the assumed dates of payment receipt and benefit payout, i.e., is it end of year or beginning of year? If the age of the insured is shown, you have to show the issue age plus the number of years the policy was in force. You also have to show the description of any abbreviated payment arrangements and a caution that the fact that a policy might abbreviate doesn't mean that it is paid-up. Also no premium columns should be left blank. That's kind of a shorthand of what our proposal contemplated. I haven't touched on the standards, but Gary will do that.

MR. BARKS: The draft that George was talking about is attached to a letter to Steven T. Foster from George Coleman on Prudential letterhead. These are not models or ideal illustrations, but they are examples of what George was talking about.

MR. COLEMAN: Yes. We put together some illustrations that would conform to the format conventions that we have recommended in this proposal. In addition, we gave examples from two different companies. This shows how companies might format the explanation page, and so there are a variety of ways you could do this and still adhere to the requirements.

MR. CORBETT: I do not think you mentioned currently paid scale and recent historic experience, which is really at the heart of the industry proposal. I am not going to review all the other methodologies, but this is an important and fairly new concept. I want to compare three terms: *current scale,* which is what is still in use, *currently paid scale*, and something called *recent historical experience scale*. All of these apply equally to all nonguaranteed elements. I will probably tend to talk about them more as if they were dividends, but think of them as equally applying to UL interest rates and mortality charges.

The current situation is that companies illustrate current scale. This means the dividends that are currently being paid on in-force policies are at specific policy durations. It is also what the companies supposedly would have paid if they had policies in force at other durations. For example, even though you have a brand new policy that was just issued a year ago and you have never had a similar policy in the past, you will see an illustration for the 20th year. Clearly there is no dividend currently being paid in the 20th year on that particular policy. It was not issued 20 years ago. However, whatever number has been put in there has been designated as the current scale, even though it is literally not paid. Actuarial Standard of Practice No. 15 would say that it has to be related to the actual paid dividends in a reasonable and justifiable manner.

There evidently has been some problems with this. I just want to use one example, but I do not want to focus on any one thing. One thing that has come up is lapse-supported products, and bonuses arising out of lapses, for instance, a bonus payable after ten years. If this is dependent on a certain number of people lapsing by that time, and the company has had no experience on this policy, it has not been unusual to show a number out there that would be predicated on an assumed lapse rate. Is this current scale? That it is current intention of management may be about the fairest thing one can say about that.

So, the industry has said, let's adopt a tighter definition of current scale. It has said we are going to develop something called a currently paid scale, which is defined only for plans, underwriting classes, and policy durations for which a company has actual policies in place or could have policies in place. If you would issue a policy five years ago in a certain underwriting class and nobody happened to buy in the third year, but people bought in the second and fourth, you could fill that in, but essentially you could not go back any further than the fourth year. Also if you started to issue the policy five years ago, you do not have a currently paid scale for six and later durations. For those that you do have a current paid scale, current dividends are actually being paid, you would use that scale. Where you do not have those values, which would be primarily at later durations, you illustrate dividends or nonguaranteed elements that are based on recent historical experience. Recent historical experience is developed incorporating only the company's actual historical experience or interest, expenses and mortality by age with no projected improvements. These words I am using are actually in the industry proposal.

MR. COLEMAN: Let me interject here, Gary. What the participants in this forum have before them is our proposal as of January 31. So, you're only going to see current scale in that proposal. However, we are about to unveil our definitions of currently paid scale and recent historical experience. As soon as Northwestern

Mutual finishes up the final draft, and we get it run through our Resource Committee, it will be out.

MR. CORBETT: These proposals are rather significant in some areas, and I want to use just expense as an example here. Under this proposal, assume a company was exceeding its expense targets, by 20% of what it had built into its profit studies. The company may not be reflecting that immediately into its current scale. If you thought it was a one-year blip in expenses, very few companies will actually cut their dividends in that year to have dividends track experience absolutely. There has always been a fair amount of smoothing in the dividend formulas. So, if you are actually paying a dividend and not reflecting those higher expenses, that would be appropriate. You could illustrate that. However, at the later durations where you did not have a currently paid scale, you would have to use your actual expenses because the proposal says you cannot project improvements. However, there are provisions for mortality assumptions that would allow companies that don't have enough of their own experience to use intercompany mortality experience.

There are a lot of problems that have not been dealt with on many of the proposals. Investment-year approaches and portfolio approaches to crediting interest always seem to cause a problem here. For example, you have a portfolio rate of 8% and a new money rate of 6%. Is current experience the portfolio rate of 8% or is current experience really the new money rate of 6%, which will tend to drag down that portfolio rate in future years? This is a problem that most if not all proposals will have to deal with through an actuarial standard of practice in a way that is fair and consistent for both investment-year companies and portfolio companies.

One thing that is not clear to me in this is whether recent historical experience would permit some amortization of acquisition expenses. I assume that would be a necessity, but I have not seen that covered. That is an example of some of the things that have not been dealt with yet. So, I just wanted to offer that.

MR. COLEMAN: Most likely.

MR. CORBETT: Very, very likely.

MR. BARKS: I want to give Commissioner Wilcox a chance to speak to that.

MR. WILCOX: Well, the only comment I would make is that, this does zero in on the issues with regard to that proposal. I think any of the proposals we deal with are going to have to be backed up with a well written actuarial standard, or they will fail in practice.

MR. DANIEL THEODORE: While we have moved onto other topics, I had two comments that were on my mind a while ago. I have a concern that we should not be trying to introduce more pages to the illustration. I think that this is a response by the company to try to protect itself sometimes more than trying to get across to the customer the complexity of the policy. Are customers really going to read it, and are they really going to understand it?

MR. BARKS: So, would you say that it is possible that a life insurance illustration is more understandable than, say, a prospectus?

MR. THEODORE: Maybe we have to work toward better standards of writing these pages. The other thing is that, while I like the way variable life is handled where we show 0%, 6%, and 12% assumed credit rates, I do not think people focus on the 6% and the 0%. I think they are focusing on the 12% because they tend to look at extremes. While this approach does show what happens when things go bad, to show 11%, 12%, and 13% would probably go further toward showing people that there is some variability, and that people should not expect exact numbers. Finally, I agree with the rounding rules that have been mentioned in past discussions on the subject.

MR. SCOTT LLOYD BERLIN: The shortcoming with using the standardized assumptions is that companies with superior underwriting and investment performance get hurt. The shortcoming with using past performance is that, especially in the face of a declining interest rate environment, it could be very misleading to the consumer. Would it be possible to allow companies to illustrate these mortality charges and interest crediting rates as a percentage of some standard rate that mirrors their prior performance as a percentage of the standard rate?

MR. WILCOX: I have to think about that one.

MR. CORBETT: It's a, if you were better in the past, you will be better in the future sort of thing.

MR. BERLIN: Yes. If you had better-than-average performance in the past, would it be possible to allow the companies that exhibited that better performance in relation to the standard to illustrate that as a percentage of the current standard?

MR. BARKS: Does this accomplish anything different than recent historical experience? Recent historical experience says you have to look to what you have earned, and you cannot credit more than that. You may be paying more than that, but once you get beyond your experience base you cannot illustrate more than what you have actually been paying. You would be able to see differences between companies in that situation, which I think is what you are trying to get at.

MR. BERLIN: Right. The difference is that, if you are only looking at that prior historical experience and if we were crediting rates that are unrealistic for the current or the future because the interest rates have been declining, if you are just looking at it as a percentage, comparing how your company did as compared to the standard and then projecting that into the future, that may be a better illustration.

MR. CORBETT: Yes, I think it has some difficulty. For instance, expense comparisons are extremely difficult to standardize because of the way different companies operate and how much is charged for larger policies and smaller policies. I think this proposal would be getting away from standardized assumptions, and would be using a long-term historical prospect rather than the short-term historical prospect that the industry is proposing. It is something I hadn't thought of, but I think it would, as you say Brad, lead to somewhat comparable results in a period of time. However, I think

that producing those comparisons might be quite difficult. That would be my reaction.

MR. DENNIS L. STANLEY: I really like the way Brad used the words "meeting policyholder expectations" because I noted that it seems like the problem we are dealing with is unmet expectations from the policyholder's perspective. I have a question first for George, and it is going to be a two-part question. If we would have had the industry proposal in place and everyone was following it back in the early 1980s with the vanishing premium or abbreviated premium payment illustrations you were talking about, do you think it would have alleviated the unmet expectations from the policyholder's perspective, or would that have just been successful in defending us in court situations?

MR. COLEMAN: Well, I think it would have helped. There is always someone who is going to be upset when there is a downturn, and it is reflected in the performance of the contract. I think it would help if all those columns had a number, and everyone knew that, if a policy abbreviated, it was not paid up, and you had to have a policy explanation page that set forth a detailed paragraph on the scheme. There is not much more you can do short of outlawing it, and if you talk to companies and agents and the NALU, that is just not in the cards. It is something you can do with a life contract. You ought to be able to do a life contract if you want to do it.

MR. STANLEY: I interpret that as saying, when you understand in advance, you can disclose it. So, maybe you are saying that we understand now that vanishing premium illustrations are extremely sensitive to the interest assumption, and, hence, we can properly disclose that sensitivity. Let me now come to the lapse-supported products because I personally believe that a lot of the last-survivor products that are on the marketplace have elements of lapse support built into the pricing. I do not think the consumer or the field forces are very well-educated as the sensitivity of vanishing premiums related to lapse supportability. Do you think that this is an area that we ought to take a look at? I think that last-survivor products, because of the size of the policies and the amount of money at stake, is a big problem for the industry.

MR. COLEMAN: I think you really have to make sure that people understand volatility, whether you solve for a policy blowing up or values being halved. I think you have to catch people's attention, and that is all to the good. I think these policies are designed to fill a need, and maybe you get to a point where a policy doesn't have any real reason to exist. I do not know that. I leave that to you, the actuaries, to tell me that.

MR. CORBETT: Denny, the only thing I would add here is that early on in this process the TRG tried to identify egregious abuses or potentially egregious abuses of which lapse supported policies were one. There was an attempt to develop a list of practices to be banned or controlled. It was soon discovered or realized that you can never do it that way. The first time you ban five, somebody will come up with the sixth or the seventh. Then the eighth will appear. The real answer is to write general principles or standards. Then people should test these egregious situations to see whether they will overcome it, but you cannot do it by saying you shall not do this and so on.

MR. STANLEY: I guess what I was really driving at is that either you illustrate guarantees, and so you do not create expectations that will not be met, or you lower the expectation. For example, in consulting, underpromising and overdelivering is the best way of meeting expectations. If we had some sort of current scale illustrations, since these are not guarantees, they very well may not be met.

MR. LAWRENCE N. SEGAL: While you can regulate what is shown to consumers, it's difficult to regulate what is said or not said. I am wondering if more could be done to educate consumers through other channels. One thing that came to my mind would be to require that a video be shown or delivered to consumers. It could be approved or even produced by the NAIC and explicitly explain what the different components are on the illustration. I would be curious to get your thoughts on this.

MR. CORBETT: Well, I guess that is like a 50-page illustration. Is it practical? Would it cover all possible policies that we might sell? It seems to me that you would have to amend it every time you did a different form, and then where would you end up when you were through? Also, I do not know why a video would be any better than a well thought through written statement that people sign to acknowledge receiving and at least looking at.

MR. SEGAL: I was thinking back to the other gentleman's comments about one footnote after another, and people probably just shove those in a drawer.

MR. COLEMAN: As Gary said, I do not know how you can uncomplicate these products. You can try to explain them in as simple a fashion as you can, but I do agree we need agents to explain these products. We do need to clarify some things, but they are very sophisticated and difficult products to convey.

MR. DAVID R. BEARD: Dennis Stanley was referring to the scenario of having had the current industry proposal in the early 1980s with respect to vanishing premium products. One thing that we have worked on in the State of Iowa is an offshoot of the industry proposal. In our particular amendment to the industry proposal we are suggesting a base illustration that has to be prepared with each illustration. The base illustration assumes that the premiums will be paid each year in the future. So, it is really a cost disclosure that is being provided to the insured at point of sale. Then this cost disclosure is updated each year. It is a re-projection using your current scale at that time. The objective is that an informed insured could take this policy update or re-projection of current scale, assuming continued premiums, and compare that against the cost disclosure that was prepared at issue. They could then track to see whether their projected values are increasing or decreasing. If they were obviously decreasing, that might prompt an informed consumer to contact his or her agent and have an actual re-projection done on that vanishing premium illustration.

MR. BARKS: George, is that a lot different than what the TRG is doing?

MR. COLEMAN: Not terribly. We do have the requirement of an update of our policy explanation page. We also require companies to advise an insured of an adverse change in the rates. Of course, a lot of companies are already doing what you are suggesting, but I think it is fairly close. We do not require the immediate transmittal of a new illustration, and I think Iowa's proposal does, but we are close.