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CURRENT DEVELOPMENTS SURROUNDING REGULATIONS AND STANDARDS OF LIFE AND ANNUITY PRODUCTS

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This forum will present viewpoints from actuaries, marketers and regulators on proposed regulation of policy illustration and nonforfeiture requirements. The forum will examine the proposed Actuarial Standards Board (ASB) Standard for Sales Illustrations, currently under development.

MR. JAMES D. ATKINS: We have three experts with us. Robert Wilcox is the Commissioner of the state of Utah. He's a member of the NAIC Life and Health Actuarial Task Force, and he's leading the NAIC's effort on illustration regulation. Walter Miller, now an independent consultant, retired as the senior vice president and chief actuary of Prudential Preferred Financial Services. He is a former chairperson of the Actuarial Standards Board (ASB) and was a member of its life Committee that originally drafted the ASB's standard on illustrations. He is a member of the technical resource advisors to the NAIC's working group drafting the new model illustration regulation, and he is the former chairperson of an Advisory Committee on Life Nonforfeiture. Shane Chalke, the president of his consulting firm, Chalke Inc., and a Society of Actuaries Vice President, has served on numerous committees concerned with nonforfeiture issues since 1986. I'm with First Colony Life Insurance Company. I will start by asking Bob Wilcox to tell us about the gestation of the nonforfeiture regulation at the NAIC level, and to tell us what's going on today in the changing world of nonforfeiture and the NAIC.

MR. ROBERT E. WILCOX: I'm a latecomer to this process because the current round of revisions to the nonforfeiture law has been going on for some time. I entered the process when I became Commissioner of insurance for the state of Utah about two and a half years ago. After I had been there for a while, I started working with the Life and Health Actuarial Task Force. The major project it was working on was the new standard nonforfeiture law for life insurance along with the new nonforfeiture law for annuities. At that time, because little progress had been shown, there was a tremendous amount of pressure from the Life A Committee to make some progress on both of these major endeavors and bring something back that they could act on. At that point, the members of the Committee generally felt that the Life and Health Actuarial Task Force served quite well as a very fine bottleneck to making real progress. Significant progress was shown, and a model was reported late last year on the annuity nonforfeiture law. However, it occurred to some of us, as we watched the lack of meaningful progress on the life nonforfeiture law last year, that we needed to step back and regroup. It was not because significant effort was not being put forward, but because different members of the Life and Health Actuarial Task Force didn't seem to be focusing on the same problem. At the December meeting in New Orleans, I made a motion that we stop working on that model, step back, and develop a statement of intent or basic premises that we would follow in developing a model nonforfeiture law. The Life and Health Actuarial Task Force considered that over lunch, came back and approved it unanimously, so we undertook the task of developing a statement of basic intent. This was put together during the ensuing three months and was approved at the Miami meeting. You have in your package the single-page, life nonforfeiture law basic premise, basic principles and consumer protection public policy. That was what was approved in Miami as the statement of intent.

I want to touch on a few things in this document that are critical to where we go from here. First, there is a tone set for minimizing the amount of regulation that's necessary. If you look at the first of the basic principles, it doesn't talk about a minimum nonforfeiture value, but rather a standard which does not significantly advantage or disadvantage either persisting or terminating policyholders. Under basic principles, noticeable by its absence, is a cash value, and I think that's a critical element of this statement. We issued a charge to the actuarial profession to provide assistance in carrying out this particular set of basic principles. The Society and the Academy have been actively at work responding to our request, and we will receive a report from them.

MR. ATKINS: As a matter of fact, Bob, I believe Shane is involved with that committee.

MR. WILCOX: Shane is right in the middle of that process, and I'm sure he will be able to give us much information.

MR. ATKINS: Shane, do you want to give us an update on what that committee is doing?

MR. SHANE A. CHALKE: The Society of Actuaries Task Force on Nonforfeiture has been in existence for six or seven weeks. We began by revisiting the age-old problem in front of us with respect to nonforfeiture, and that's to delineate the appropriate principles. In other words, what is nonforfeiture regulation attempting to accomplish. This has been debated back since the 1860s with Elizur Wright and then through the now famous Guertin Committee and the Unruh committee, but we took another crack at it, attempting to clarify these principles in the modern world. We were able to reduce this process to four principles which I'd like to articulate.

The first deals with the principle of equity. We always talk about equity when we talk about nonforfeiture, but rarely do we tightly define equity. The first principle we arrived at is that the principle of equity is between persisting policyholders and terminating policyholders. Now does that sound radical or surprising? No, not at all. However, this principle, which is felt intuitively by many actuaries, is oftentimes voiced in ways that are less workable, in ways that tend to imply that the equity principle is between the terminating policyholder and the financial institution. You often hear it voiced as the phrase that Bob read: "terminating policyholders do not advantage or disadvantage persisting policyholders." Many of us feel that sentiment but, articulated in that manner, it becomes very difficult to apply. It makes the presumption that the insurance enterprise is a zero-sum game, that there's a single pot of money and whatever persisters get, terminators don't and whatever terminators get, persisters don't. In fact there are more parties to the game, notably shareholders. In the modern world, capital structures of companies are so complex that it's extremely difficult to look inside the company and assess whether any particular termination benefit has an impact on persisters. We've taken this principle and articulated it in a simpler fashion, so that we only need to look at the persister's deal. We can judge the equity of the termination benefit in relation to the persister's deal.

The second principle, related to and implied by the first, is that nonforfeiture regulation should address the relationship of benefits for terminators and persisters, but not whether the policy itself provides reasonable benefits. In other words, it is not appropriate to use nonforfeiture regulation to regulate whether or not the persisters actually have a good deal and, in fact, attempts to devise enduring nonforfeiture principles are often hampered by trying to ensure that the policy is a "good deal." There's a tendency to do that by regulating the rate of return to terminating policyholders when in fact we should limit ourselves to providing terminators with a deal commensurate to the deal they signed up for in that policy as a persister.

MR. WALTER N. MILLER: Does that mean that if a law or a regulation were written in conformance with this principle, it would not have minimum nonforfeiture values specified in a quantified way?

MR. CHALKE: I think that's correct by implication. If a policyholder buys a contract which is by some measure or standard a poor deal or a bad deal, then the termination benefit is likely to be a poor deal or a bad deal. In other words, we're comparing the contract that a policyholder purchases with the commensurate nonforfeiture benefit. What we're trying to do is establish the principle that terminating the contract does not forfeit the deal you have as persister. It says nothing about the value of that deal. I think Walt's right that it's very difficult, if possible at all, to determine these values in some kind of abstract tabular format as we've done historically through the standard nonforfeiture law.

The third principle is more of a pragmatic effect than a principle. We feel very strongly that nonforfeiture regulations should not mandate cash benefits. I say this is pragmatic because of the extreme difficulty this industry has faced by having tabular-based cash benefits. The implied options that we are required to write in the contracts give us fits with asset liability management. It puts us at a competitive disadvantage with other financial intermediaries because we are, in essence, required to include an option in the contracts that is not properly valued by policyholders. Thus we're incapable of appropriately charging for that option, putting insurance companies in a precarious position.

MR. MILLER: Again for clarity, I think I hear your group saying that under that principle, a company could offer cash benefits but would not be required to do so.

MR. CHALKE: That's exactly right. We would like to think we're not so naive as to think that if cash benefits were not required they would cease to exist. In fact, cash benefits are a very powerful driving force in a large sector of the types of policies that we offer in this industry, and there's no doubt that cash benefits are material and they're a material component of the contracts. If no cash benefits are required, it's not realistic to think that they would not still be a major force in this industry. We feel strongly that although the nonforfeiture regulation should permit the offering of cash benefits, it should not require the offering of cash benefits. This would provide companies with more latitude to design benefits better tailored to what consumers want, and more manageable from a risk management perspective.

MR. MILLER: That was one of the recommendations made by the Advisory Committee that Shane and I worked on almost ten years ago, and it joined most of our other recommendations in being trashed by the then NAIC working group. So things are coming around.

MR. CHALKE: I think times have changed. We've been through a couple of interest rate cycles and that helped awaken our awareness. The fourth principle that we've arrived at might seem superfluous at first but I think is necessary once you've stated the first three, and that is we feel that the regulation should permit companies to offer additional nonforfeiture benefits over and above those that are required by the standard of equity. I think it's necessary to say this following the first principle which talks about equity between persisting and terminating policyholders. It's felt by the committee that from a public policy standpoint, the purpose of the nonforfeiture regulation is to protect people that surrender their contracts. The counterpart to that is not necessarily true, that it's necessary for a nonforfeiture regulation to protect those that don't surrender their contracts. So we think it's highly desirable to allow the payment of nonforfeiture benefits that are greater than those required, and, in fact, this may be a necessary provision in order to allow insurers to continue to offer tabular guaranteed cash values. If we look at this principle of equity from an economic standpoint, valuing the persister deal and duplicating that deal on the termination side, well, obviously such a value floats with economic conditions. In a high-interest-rate environment, the persister's deal is worth a different amount than in a low-interest-rate environment, likewise, if mortality is high versus low. The parity changes over time. If we want to continue to offer contracts with tabular fixed cash values, and I think they're a substantial and important part of the market, occasionally that value will float above the economically driven termination value.

MR. WILCOX: Shane, I think that the first three principles correspond quite precisely with the NAIC Life and Health Actuarial Task Force's intent. I think the fourth one doesn't conflict but it may seem to conflict if we don't look at it carefully. Without delving into it deeply, it may seem that the fourth principle is in conflict with the first principle. While I agree that it's not a zero sum game, you need to be very cautious about designing around the "not less than" principle. By implication, if you're going to pay out more to terminating policyholders than equity requires, then the only way the persisting policyholders can be made whole is through a sacrifice from the other participants in the game, that is the stockholders and other equity holders.

MR. CHALKE: I agree. Most of us were gearing toward the idea that we do not want to inhibit a company's ability to write contracts as they write them today. Most people would argue that at least some of the contract forms on the market today have termination benefits which are more handsome than persisting benefits. I think we have perhaps a more practical view than the fourth, but I think we could probably market it better.

MR. ATKINS: I received a letter from James Hunt of the Consumers Federation of America. In it he asks, "If it cost $150 to put a term life insurance policy on the books, how can you justify a $1,200 whole life premium having a zero-first-year cash value? How can you explain that to your mother?" Can we get some comments from anybody? Do you think organizations like Mr. Hunt's will have a problem with a "no cash required" type of basic principle?

MR. MILLER: I think that some of these organizations will question low or zero early cash values on traditional permanent policies under any circumstances whatsoever. It doesn't matter what principles you're supposed to be working under, it doesn't matter what the law is, they will say this shouldn't be allowed. They are going after the traditional, front-end loaded, field compensation plans.

MR. ATKINS: What do you think would happen if you introduced whole life policies and universal life policies in your markets with no cash benefit?

MR. MICHAEL ROSCOE: I think you'll start to see the effects of the open market. There's no reason that you need to have regulated values. Let the market determine them. If Mr. Hunt's organization thinks that's an outrageous charge, then don't buy a policy. Somebody will come out without a front-loaded, heavily commission-driven product. I don't think there's anything wrong with just allowing things to happen. Some people will want to have policies for the death benefit and won't want to have to fund cash values. Other people will want to have policies that are there for the tax deferral on the cash, and that's the kind that they will be looking for, but I think you'll just see regular market forces starting to work.

MR. CHALKE: There is a controversy that exists in Canada with so called lapse-supported policies with no cash values. I think that technology will render that argument historical. Yesterday, there was a session on securitization of liabilities. That's right around the corner in many ways. Look what securitization has done to the mortgage market. It's made the movement of capital extremely fluid. It has increased the efficiency of capital movement by a factor of about 10,000. That's coming right around the corner with liabilities and, once liabilities are securitized, there won't be any such thing as a level premium death benefit for a life policy that has no value over time. Obviously, the contracts have an intrinsic value to them. The issue is whether that value can be arbitraged by the company or by the policy owner. If liabilities attain the ability to be securitized, then you'll likely see a fairly powerful secondary market in contracts develop. If you're an insurance company that offers level premium term to 100 with no cash values, your ability to rely on lapse as a source of value in the development of financials would be very much inhibited by the fact that these policies could be securitized and maintained in force by the investment community. So I think that argument dies a slow death over the next few years.

MR. WILCOX: It would be critical in that process to get on board with the idea of better disclosure to the consumer of what they're buying. We lack a great deal in terms of disclosure, but I'm convinced that many of the things we have regulated with a fairly heavy hand could be unregulated if we have some strict requirements on disclosure. It's a better form of regulation in my opinion.

MS. BARBARA J. LAUTZENHEISER: I think it is important that we look at all of these issues rather than a single issue, just as Shane has talked about securitization and Commissioner Wilcox has talked about disclosure being critical. We need to look at all of these things interacting. I think another one of the free market things that will occur is that, traditionally, the cash values have cost money and have decreased the value of the contract. If we start developing contracts that have no cash values, we may, as is now appropriate in some annuities, end up better able to pay greater values which will be seen through the disclosure laws. There will be those people who will want the greater long-term values as opposed to the more liquid cash values. I also believe that it is imperative that as an industry, we begin to reemphasize the insurance benefits we sell as opposed to the investment side of our contracts.

MR. CHALKE: I think there certainly will be a market for all of that. The impact of nonforfeiture benefits is more than just the value of the cash-out option itself. It's the time horizon of investment that is so critical. In the annuity market for example, people disagree about the duration of a traditional single premium deferred annuity (SPDA). Most people would say it's somewhere between two and four at time of issue, maybe falling to as low as one and a half or so at the end of the surrender charge period. This puts insurers in a position where they need to invest at a short horizon. There certainly is some degree of consumer need for products that have a much longer horizon in their ability to build wealth for retirement. That may be a novel concept in the annuity market, but we do call them annuities still. If you're investing for a three-, four-, or five-year horizon, you're losing a tremendous amount of value accumulation over time in comparison to adopting a longer range horizon. So I think that's one of the real positives allowing contracts to be sold without cash benefit.

MR. MILLER: What Shane just said is imminently sound and prudent, but not all companies invest soundly and prudently all the time given the competitive scrambles.

MR. CHALKE: Going back to the mortgage market, when you have a residential mortgage, over time you have absolutely no clue who owns your mortgage. In fact, you, as many of you are representatives of insurance companies, own lots of residential mortgages and you don't know whose they are. They're wrapped up in blind pools of which you have no specific demographic information. I think almost all of us find it distasteful to have people betting on other people's lives. However, the same technology that's applied in securitization of other financial instruments can be quite readily applied to insurance contracts and have them wrapped into blind pools. Again I'm engaging in a certain amount of speculation.

MR. MILLER: You're starting to see it right now with some of the so called viatical companies, the ones where you have specific, highly investment-oriented deals being made related to a specific accelerated death benefit arrangement on a specific person.

MR. WILCOX: In some instances over the last two or three years we have seen some element of fraud on the viatical side. But we've also seen some cases of reverse fraud, where individuals have falsified blood tests to indicate they were dying in order to get the viatical contract when in fact, they were in fine health and expected to have a long life in which to spend the proceeds. So, if you don't institutionalize it and use the blind pools and other kinds of techniques to make sure it is done properly, it won't work. The reverse underwriting necessary to securitize the death benefits is at least as critical as the up-front underwriting needed to issue the contract.

MR. ATKINS: After years of work, the NAIC has published a proposed standard nonforfeiture law for deferred annuities. While it does give you an option to have an annuity that does not have cash values, it very much regulates cash values, if you have cash values. If there's someone here in the audience who was involved with this, I'd like to hear from you because it sounds to me like this is back on the table. Maybe with these basic principles we can go back and say that minimum cash values, based on regulated loads and charges, are not in keeping with the basic principles, so this entire document should just be scrapped. Does anybody want to propose that to the NAIC?

If it works for a life insurance policy, does it make sense that if you have a deferred annuity and you're allowed to annuitize to say a ten-year certain payout that you don't need a stated cash value? You have a stream of income you can offer a bank to amortize a loan or you can simply sell the contract outright, sell the benefits. That seems to work for me.

MR. CHALKE: In fact, if you follow our four principles for an SPDA, there is no unique required nonforfeiture benefit. If what we want to do is let terminators enjoy the same deal that persisters get, well, by doing nothing, they in fact have that deal. So that's a very simple application of these four principles that you have no specific nonforfeiture benefit for SPDAs.

MS. LAUTZENHEISER: There are some of us who believe that it would be beneficial to, I don't want to use the word stop, I don't want to use the word delay, but to look at the annuity nonforfeiture law as we concurrently develop the life insurance nonforfeiture law. I believe the principles for life insurance and annuities are the same and the nonforfeiture laws should merge. Even more importantly, I am looking for laws that will take us well into the 21st century involving all of the things that we have been talking about. But in addition, I believe that as a result of technology, we should be moving into a merging of the concepts. We have a division of annuities and life insurance and health insurance, but they are coming together in product design. That may be appropriate for a product design. How do we tell an annuity from a life insurance contract any more? There's a death benefit in many annuities. It's smaller but how do we distinguish between these things? If we were able to merge them together in some way, it would be beneficial. They should be based on similar principles to take us into the 21st century.

MR. WILCOX: I think that's accurate, and some of us would have preferred an even stronger statement in the life nonforfeiture law statement of principles that set a measure of consistency between the annuity nonforfeiture law and the life insurance nonforfeiture law. The need for consistency was used as part of the argument because Section 9 of the annuity nonforfeiture law refers to no-cash-value annuities. There is some consistency already provided for in this proposed draft. I think you'll see us going back and reviewing some of those consistency issues.

MR. ATKINS: I believe we have at least one maybe more members of the audience who work for a state insurance department. I'd like to hear what you think about the likelihood of an insurance department supporting this type of radical change. Anyone want to volunteer for this spot?

MR. NATHAN F. JONES: When I hear these discussions at actuarial meetings on this subject, it always makes me sad because it shows the conflict between the world of the actuary and the upper middle income group with whom actuaries feel a common understanding. Even in my position, I've seen this conflict. That's parallel to the difference between the federal view of regulation of all kinds that was brought in particularly with the Securities Act of 1933, and the old traditional state basis which goes back at least to Elizabethan times.

There was a statement made about the impact of illustrations but what good does that do if nobody reads the illustrations? And the state view, which I'm trying to share by necessity, is that people can't be trusted to act in their own interests. Somebody has to decide for them, in many cases, what their interest is, and that's in two dimensions. First, with most of the policies that are sold in this country, the insured or policyholder does not read the material. That applies also to a great deal of the securities that are sold with prospectuses under the Securities Act. Second, of those who do read them, how many, in the mood of optimism developed by the selling agent, think, "Yes, that's all right for now and that's how I feel now, but how will I feel five years down the road or ten years down the road under various scenarios." I think the life insurance business has a lot of experience with that. I assume that the policy loan problem is subsumed in this business about cash values, but that of course is a very closely related matter and even more troublesome.

MR. ATKINS: Anybody else on nonforfeiture? It looks like we will have an interesting time ahead. It may take a few years to get anything like this through, and when did we start, Bob, you said ten years ago maybe?

MR. WILCOX: Well, the most recent round is ten years ago and, as Shane was saying, the process has been going on for about 110 years.

MR. ATKINS: The tabled universal life nonforfeiture proposal required that a policy not be lapse supported—it must be self-supporting. It restricted persistency bonuses and even required an annual report. I didn't see that here in the four basic principles, but maybe we'll find it somewhere else.

MR. WILCOX: And maybe not.

MR. ATKINS: The NAIC has proposed a life insurance illustration regulation. The draft I have is dated April 21, that's fairly recent. I hope you've had a chance to look it over. I'd like to start out by posing a question and that is, what is the impetus behind introducing this illustration regulation? Why are we doing this?

MR. WILCOX: Efforts began in the NAIC to look at the quality of the illustrations as the investment market turned steeply downhill and premiums that were supposed to vanish didn't. That put tremendous pressure on the companies and on the regulators of the companies to look at this particular issue. If you look at last week's copy of the *National Underwriter*, there was word of a lawsuit, actually two or three lawsuits, that had been filed over the issue of reappearing or nonvanishing premiums. That points out the initial problem. Whatever we did to illustrate those contracts when they were sold, the policyholders did not understand the contingent nature of that vanish. That's the underlying reason we got into this.

MR. ATKINS: You mean just because they didn't understand the vanishing premium illustration we have all this regulation being imposed?

MR. WILCOX: If you try to get down to the catalyst that made it turn the corner, that's probably true.

MR. MILLER: Perhaps that was the catalyst, but I have a somewhat different point of view as to what triggered all this. Obviously, I have been an industry person for the 43 years that I worked actively, so understand that as a background for what I'm about to say. I would also apologize for trying to look inside regulators' heads, but here's what many industry people perceive. In addition to the widely publicized sets of problems that had to do with the vanishing premium illustrations, much of that had to do not so much with the illustration, but how the illustration was explained, if at all. I mean that's a somewhat different animal. There are many industry people, however, who feel that for better or worse, there is a perception among many regulators that too many companies are being too aggressive in the bases underlying their illustrations and we need to do something about that. I think there are several new model regulations that your group is developing and there's obviously some proposed actuarial standard of practice that addressed this point.

MR. WILCOX: I think you're right, Walter, in a significant respect. The fact is that a minority would be inclined to make those overly aggressive assumptions and produce unsupportable illustrations, but every time one company would take that stand and use assumptions for the illustration that don't make sense, there's another company that competes with them and feels compelled to play in the same ball park and then another company that competes with them. In the absence of regulation on those who would be most aggressive, the problem grows, but your point is well taken.

MR. ATKINS: Does anybody think the market could take care of these excesses on its own?

MR. MILLER: It demonstratively hasn't. I published an article in a CLU journal several years ago where I wrote about what I call "The Illustration Is The Product," a syndrome that unfortunately pervades our industry. To agents, potential customers, their advisors, and some regulators, the illustration is the product. If this illustration looks better than that illustration, then this policy is a better policy than that policy and that means this company is better than that company.

MR. WILCOX: When I came into the process of developing standards for illustrations, one of my big concerns was that the actuary's role in this process was too insignificant, that the actuaries were the ones who had both the technology and the integrity to bring some discipline to the process, and they were in too many instances uninvolved. A major part of what we have tried to do with this standard on illustrations is to empower the actuary. In this model we've required the board of directors to appoint an illustration actuary. There's some intentional similarities here with the appointed actuary where the illustration actuary will have an obligation to perform to the standards of the Actuarial Standards of Practice, and will have to report those results not only to the board but to the regulator. This may not be sufficient but I think it's a necessary step in bringing some discipline to the illustration process that can at least get us started on the path you're suggesting.

MR. ATKINS: Let's hold that point for just a moment and survey the audience. Raise your hand if you are involved with your company's illustrations or if you are aware of how they are determined. Now you people who have your hands up, how many of you can control what is shown in that illustration or feel you have significant influence? I'd say most of the people who know what was going on have significant influence. So maybe it's not so much driven by the marketing guy saying, cut those costs of insurance charges.

MS. LAURA M. MOCKRIDGE: I have worked for other insurance companies dealing with illustrations and this phenomena of being involved is very new. At my prior company I was in charge of looking at other companies' illustrations. I called the company and their actuaries didn't know what was in the illustrations. It was the marketing department. This is new that the actuaries are involved.

MR. THOMAS L. BAKOS: I have perhaps a more simplistic view of what's going on with respect to illustrations and their acceptability. I think what's happened is that in the mid-1980s, interest rates were the highest they had been in this century, but they came down, and we all know that a universal life or a traditional participating policy's performance is very dependent on the level of interest. Interest rates came down and policies issued in the 1980s did not actually perform as well as they were illustrated. If you go back a little further, policies issued in 1970 or 1975 are performing better than illustrated, and no one is complaining about the inaccuracy of illustrations in that situation. So it seems to me that the basic problem is that interest rates have come down, and people don't like the way their policies are performing versus how they were illustrated. You can modify rules and regulations and certainly there are some abuses in illustrating life insurance products that should be corrected, but I think the only thing that will eliminate this problem altogether is if interest rates start going up again.

MR. ATKINS: If we stonewall long enough, the problem will disappear if interest rates don't spike up and spike down but just go up and stay?

MR. BAKOS: I think we shouldn't consider life insurance as outside of the realm of all consumer products. I think people can have problems with other products as well. Automobiles don't perform as well as they're illustrated to perform, but perhaps people expect that. Life insurance is just a product. Unrealized consumer expectations surrounding life insurance are just like those with other products.

MR. MILLER: One thing that has exacerbated the problem of disappointed policyowners accompanying the flow of market interest rates is that this immediately followed almost a 30-year period when, as you correctly commented, everything went up. Every company had its own version of a mountain chart. Here's a policy we issued 20 years ago, here's what we originally illustrated, and here's what we actually paid. At least a generation and one half of life insurance agents, field people, even home office people and their customers grew up thinking that a mutual company would never pay dividends less than what was illustrated. As that sunk in, collectively we forgot to talk about the fact that dividends weren't guaranteed. We very seldom made that point up front during the sale near the end of that period when things were about to turn around. We never showed alternate illustrations at less favorable interest rates to show the potential volatility of policy performance if conditions change.

MR. ATKINS: I showed a current interest rate, an assumed rate, and a guaranteed rate.

MR. WILCOX: But you weren't a sales representative were you, Jimmy?

MR. MILLER: I never saw one during those years.

MR. CHALKE: I agree with Mr. Bakos' comments. The bigger issue here is just a recognition of the fact that we sell products with a nonguaranteed element. You can look at the proposed illustration regulation and ask yourself whether any of the elements of this would change the current state that we're in with respect to the image and integrity of the life business vis-à-vis the consumer right now, and I'd say—mixed. Some of it would potentially help. Having a consumer sign illustrations sounds like a good idea. Many companies are already doing that in response to the environment, but some of the more mechanical elements requiring so called nonlapse-supported scale, the self-supporting scale, the discipline scale, these things I think have very little to do with the issue right now. There is a minority of institutions that have illustrated aggressively and out of the bounds with what's sustainable, but that doesn't change the fundamental issue that the average credited rate in the mid-1980s was 12% or 13% and the average credit rate right now is 6–7.5%. I don't care whether you had a discipline scale or an undisciplined scale, the dynamics of those contracts have changed considerably over the past ten years. My opinion is that we're attacking the wrong problem in illustration regulation and, in fact, creating a framework that actuaries will have to deal with that's somewhat at odds with economic reality.

MR. WILCOX: What's the real problem then, Shane?

MR. CHALKE: I'll say before I answer that I don't have a good answer. I think the real problem is one of consumer education and better disclosure. How do you get that to happen? I'm not entirely sure that we can look at some of the parallels of the mutual fund industry which now has a several trillion dollars in funds, where the level of consumer awareness has risen dramatically in the past five years. Maybe not dramatically enough, but certainly it has been driven mostly by market forces. That's lumpy, bumpy, and sometimes insufficient, but the level of general consumer knowledge about mutual funds has gone up by, I probably wouldn't think it would be exaggerating to say, a factor of ten in the past five years. I expect the same thing will descend upon us in the life business.

MR. WILCOX: I suspect the difficulty of understanding a mutual fund product is an order of magnitude less than the difficulty of understanding a life insurance product, and a great deal of our problem is caused because the people out there marketing our life insurance products are trying to market it against and like mutual funds. Until we start to market it as life insurance and describe it and teach the consumers about life insurance, they're not in any position to make those kinds of judgment calls.

MR. BAKOS: I think there's another factor here that you have to consider, and I'd be interested in hearing Commissioner Wilcox's view on this, and that is just the basic gullibility of people. Yesterday we heard there are apparently some fairly sophisticated investors who invested $2 million expecting to double it in six months. The basic premise with respect to life insurance is that there are values that are not guaranteed. It should be a very simple concept to get across and yet we've been unsuccessful. If you have people out there who believe they can double their money in six months, how will you ever convince everyone that dividends are not guaranteed.

MR. CHALKE: Those illustrations were too aggressive I think.

MR. WILCOX: Well, I have seen those kinds of investments out there where you have two choices. You either will get ten times your money or you will get nothing. I won't comment on which is most likely but when we set down the principles that we wanted to follow with this illustration model regulation, we indicated that we wanted to change illustrations from a sales piece to an education piece. We wanted to be educating consumers about what they were buying. We've been successful in that a little, but not nearly as much as we would have liked to have been. However, I think we have made some progress in this illustration model. It's not a work that we can say, "Now we're done. We can sit back and policies will be appropriately illustrated from here on out." There will be problems that will come forward that we don't know about yet that we will have to continue to address, but I think we have tried to educate people. With every year that goes by and with every generation, the people in this country become more aware, more astute, and more competent in the purchases they make. Are they where they need to be? Nowhere near. As we go into this information age, probably most of you would agree that our biggest problem is sorting out all of the information that comes to us. I think we're making some progress with this illustration model, and the illustrations that we produce in 1997 taken as a whole, not individually, will be more reliable, more responsive and more understandable than the illustrations that we're producing today.

MR. MILLER: This will give us a chance to do a better educational job with our agents and our customers because we're going to have more useful raw material to work with.

MR. WILCOX: You're right, Walter.

MR. MAHIR DUGENTAS: In my opinion, the only good thing about this document is the Section 7, Part D (signature requirements). Everything else I think is going too far into the regulating of illustrations. In my opinion, illustrations are just a sales aid, almost like an advertisement in the newspaper. A customer has to read it, be aware of what's in it, but a customer may not be able to do that by themselves. Then an agent has to come into the picture and explain it to the customer. We pay agents top dollar and part of that is his work in explaining to customers what they are buying. So I like the fact that under Section D.2 the agent has to sign the statement. I would probably expand on that statement so the agent is definitely explaining to customers what they are buying in detail and they sign that. Once these two signatures are obtained, I think the rest should just follow itself very clearly. I'm just saying that we should pull the insurance company out of the illustration equation as much as we can because there's plenty of regulations and issues companies have to go under. Illustrations are just an additional step I don't think should be part of a company's regulatory burden.

MR. CHALKE: I'd say also as written, it's going to be very difficult to simultaneously comply with it and do the proper things to build long-run economic value. The concepts are a bit dated. The concept of self-supporting has a nice feel to it, but the way it's mechanically written it is practically impossible to comply with the requirement to use expenses allocated in a sound manner. Well, I'm an economist. There is no sound manner of allocating expenses. One doesn't exist. Expenses shouldn't be allocated. That's a bold statement, but that's what economic theory supports.

MR. WILCOX: But then how do you deal with the issue of companies who build illustrations around distorted expense assumptions? Maybe you can't allocate expenses, but there's ample proof you can distort them.

MR. CHALKE: If it is necessary to build illustrations around the expense structure, I think utilizing the pricing analysis would be a better approach. Pricing analysis will oftentimes utilize expense and recovery assumptions built around the concept of lifetime customer value. Under this concept companies issue what would be called loss leaders under a strict, hermetically sealed standard, but with the idea that they're attractor products or that you're building a relationship with the customer that has a longer, more lasting value. This is very common with other financial intermediaries. In fact, in the pricing process these days, very often people are looking at expense structures in a far more sophisticated way than allocated expenses. This regulation will have a tendency to cause people to back-peddle, allocating expenses the old fashioned way as an extra layer. It will simply serve as an extra hoop to jump through for the illustration.

MR. WILCOX: From a regulator's point of view, it seems that the other hoop is a hoop made out of air. If you're going to have to jump through a hoop, it should be one that you can define and that will have meaning in controlling the distorted illustrations. It seems that you do have to have some sort of a definition you can work with. The other approach would seem to allow more than enough latitude for those companies who are inclined to distort illustrations to continue to distort them and perhaps distort them even more.

MR. MILLER: I would just like to add that in its letters of transmittal and its announcement of the hearing on this exposure draft that will take place, the ASB has specifically asked for any and all comments, but has said they are specifically interested in comments in several areas. Among those enumerated are the self-support test, the lapse-support test, and the approach to expense allocation that is in this exposure draft. There is a lot of testing that should be done and should get some publicity as to how this standard is likely to work in the real world. The ASB Life Committee tried to do a chunk of that testing, but we couldn't do it all. We are hoping that we get a lot of comments to the effect, "We tested these out in my company on these kinds of policies and the tests seemed to be reasonable because. . .," or "They didn't seem to work because. . ." We can only find that out from the broad constituency of the profession.

MR. CHRISTOPHER H. HAUSE: In my mind, the problem occurs not at the time of illustration, but in our deficiencies in reillustrating the products in the annual report. Many times it appears that the insured is attempting to buy something and his question is "What can I pay for eight years that will pay up a certain level of death benefit?" I think two things happen even if, for example, he does get an annual report of a universal life plan and his question isn't answered. "How much more does my premium have to be to achieve my original results?" We've taken some steps to try and eradicate that by using comments and various codes on our master file. We reillustrate every year and we invite the insured to send us a letter saying, "This illustration doesn't meet my needs. I wanted to know this bit of information," so they can take proper steps to recognize the change in interest rate environment. Much of our "reappearing" vanishing premium problem could have been eradicated by an early warning system that says, "The interest rate environment has changed. You need to increase your premium by 20% to achieve your original goal."

MR. WILCOX: In our debate on this particular subject, some of us on the working group advocated that there ought to be annual illustrations. The industry basically said, it couldn't do it, and so we went to a posture where illustrations need to be available each year and the company needs to advise the consumer as to how to get it, but not necessarily to provide it automatically each year.

MR. HAUSE: We find it also to be a terribly good marketing tool on a universal life product line for premium persistency. People realize that if they stop paying or get lazy with a flexible premium policy, that their policy will erode over usually a very short number of years, especially in the earlier durations. In some cases it's sold on the basis of comparison of values. In other cases, the person is asking a question like, "What can I pay to pay up the policy in seven years?" If I bought a camera down the street and when I got back to my hotel room, the shop owner called me and said, "Oh, by the way, you owe me another $100 for that camera," I would feel exactly like many of the vanishing premium victims have felt. I understand the lawsuit. I think we could have avoided the problem through effective reillustration.

MR. ATKINS: Let's go back to the question of what an illustration actuary is. I'd like to ask you if you think the illustration actuary as a concept is going to enhance or diminish the position of an actuary with the public or with the individual company. Is it a good thing?

We're going to name an illustration actuary who has certain duties to perform. Is that going to make the actuarial profession better respected or is it going to somehow put us at odds with our bosses and the people who sign our paychecks?

MR. BAKOS: I think it's important to make someone responsible for what is going on in a company, not just illustrations but all the other things that companies do. I think it's important to have some personal responsibility because then I think things will tend to be done right more than if it's just a nebulous kind of thing. I think there will be many effects with respect to naming an illustration actuary. One of the things the illustration actuary could become is a target and that's a bad thing, but I think it will enhance the profession because it will give the word "actuary" a little broader exposure. People will start getting a better idea of what actuaries do. This is one of the things that actuaries do, so I think it's a good thing.

MR. WILCOX: On our early drafts was the requirement that the illustration actuaries sign every illustration, not just certify to the commissioner once a year.

MR. DAVID K. SANDBERG: I find this a very intriguing concept because I don't think we'll ever have perfect illustrations. I think the principle that's at play here is who should be minding the store. The issue is either going to be the NAIC will try and adopt some kind of formulaic approach that has a rule that anybody in an insurance department can pick up and measure and read and say this fits or it doesn't fit. I think they struggled through that issue on the valuation side because you used to have the annual statement and it would say, we're solvent, and then the question came, well, how can the insurance department tell whether some hidden issues are going on? I think the realization was you look to the actuary. This allows discussions to start occurring inside the company. The actuary is accountable on the regulatory side, but he gains a voice within the company, as Mr. Bakos said, to articulate the issues that need to be addressed in the company. I'm excited to see the principle. The 1990s are the age of principle-centered activity, and I think to the extent you can craft something that's centered on principles, it will last a long time. My reservation on the illustrations is to the extent that you start trying to define a formulaic self-support test or persistency test. Maybe there are some issues to look at there but I'm excited to see some principles behind it. For example, on the valuation side, I've even seen the evolution over the last few years. It used to be, you should pass all your mandated seven scenarios. In the last year or two, the regulators have started to realize they're useful as a benchmark and a screening device but, if a company is obviously going to fail an unrealistic scenario, it's just a stress test. It's meant to identify and articulate what's happening to the company. I've been very excited to see the regulators respond when they recognize a professional is minding the store. I see the same possibilities for the illustration actuary if he can get articulated and flushed out in the legislation.

MR. MILLER: Let me tell you one example of that. There are two large companies, each with good reputations. One of the companies introduced a new policy. The leading product actuary at the other company was told, "That's a good policy, we like the design so develop one for us that clones their design but it has to out illustrate them." Now that happened, and I believe that's not the only time that something like this has happened. Do you think there's any truth to what I say?

MR. ATKINS: I thought that happened every time.

MR. CHALKE: I thought so, too.

MR. MILLER: Bob talked about empowering actuaries. With an illustration actuary in the picture, I think there is a better chance that the profession can make a prudent voice heard in making some of these business decisions.

MR. ATKINS: The key responsibility of the illustration actuary will be to certify that the disciplined current scale was based on reasonable assumptions, and somehow we're going to have to prove what that is. We'll come back to that.

MR. DAVID DE HOOGH: Being from a smaller company, I look at the illustration actuary as just another sort of added designation. I just think that the companies themselves need to be responsible for the illustrations they're showing. In a small company, if you give the illustration actuary title to somebody then they will expect that since they're putting their name on the line, they deserve more money. Or you will end up hiring a consultant who will say, "If you want me to be the illustration actuary or the designated illustration actuary, that's an extra charge." I think companies just need to be responsible. The whole concept is good, but I don't know if the designation of an illustration actuary is necessarily needed.

MR. ATKINS: We had a comment earlier about the policyholder signing the illustration, and I think our speakers thought that was a good idea and maybe should be expanded on. Does anybody have a contrary opinion?

MS. LYNN FRIESEN: I have a concern from a cost standpoint. If for some reason the illustration didn't come in or the policy is going back out, the model regulation requires us to send out an illustration at issue. The policyholder is to sign and return it, but there's no incentive for them to do that. Odds are they will throw the illustration away. If it's a mail order case and we have a significant block of business that is direct-written, there is no requirement for the policyholder to return that receipt. What are the consequences? How do we prove that we mailed it? How can we keep that record of the signed illustration if there is nothing that would require the policyholder to return it?

MR. ATKINS: What will happen if they don't send it back?

MR. WILCOX: Those were issues that we talked about quite a bit in our last meeting as we were trying to solidify this particular area. I think you can probably create some incentives. On those cases that have an agent involved, you can certainly withhold the commission until the statement is signed, and that would be an appropriate way to exercise some control. And I think even on the direct-written business that's sold with an illustration you're capable of creating some incentives to make sure it takes place. The concern from regulators on the other side is that if you were in fact intending to mislead with the illustrations, you can make it more and more difficult for them to sign in order to get around the illustration requirement which is something we didn't want to do. I'm sure there will be some sorting out to do to make sure that it becomes workable, and we want it to be workable. We don't want it to be overly burdensome, but we also didn't want people to have broad paths around the rule.

MS. FRIESEN: I understand the need to get it back signed, but do you have any suggestions on the direct-written business?

MR. ATKINS: Where there's no agent involved?

MS. FRIESEN: No agent involved.

MR. WILCOX: The policy becomes effective when they sign it and send it back.

MR. ATKINS: I don't know what the court will say about that. Usually they become effective when they pay the premium, before the policy's even issued.

MS. FRIESEN: If we have the money, the states will not let us avoid the liability.

MR. WILCOX: I understand that there are some conflicts in that regard.

MR. DUGENTAS: I see the problem with direct marketing. It's just like the mail order business. If you buy a camera from an out-of-state company, you take an extra risk. I think that could simply be part of the direct mail business. The customer has to be aware there are certain risks associated with buying this type of a policy that they wouldn't have if they dealt with an agent face-to-face.

MR. WILCOX: One of the greatest protections that comes from the signature of the policyholder is back to the company and the sales representative. Let's get into the problem I mentioned at the outset that brought all of this about, that is the premiums that didn't vanish. When that situation arises in the future, if you were able to pull out the original illustration that very clearly pointed out the contingent nature of the nonguaranteed elements signed by the policyholder, there's a much weaker lawsuit involved. I think that it is very much to the benefit of the insurers to have that particular requirement in place.

MR. ATKINS: In the standard, we've talked about the disciplined current scale. That concept has been around for a while now, and it looks like it's the one with the most momentum. The disciplined current scale is a set of policy cost factors, cost of insurance rates, interest rates, and expense charges based on some provable assumptions as to mortality, interest earned, expenses in the company and persistency. Someone will sit in judgment of what those good, reasonable standards are. I feel like we will be on trial for our pricing assumptions. If one company is more aggressive than the other because they have a tighter underwriting standard, that's allowed. But if I do that, I'm afraid one of my competitors will say, "Hey, Jimmy's messing up, he should go up before the Actuarial Board for Counseling and Discipline."

I don't doubt that they will. You have to designate in advance if a particular contract form will be using an illustration or not. If you say it's not, you are not allowed to use an illustration. If you say it is, you must use an illustration. I know we sell term insurance policies with or without an illustration. It depends on whether the agent feels he needs to explain the policy to the consumer, and I'm afraid that requirement, in combination with the requirement to get a signature, will put a real damper on the economic flow of marketing policies without enhancing the consumer understanding of a ten-year term plan.

MR. WILCOX: Well, one of our concerns is that the agent who chooses to sell without the illustration is doing that when it's to his advantage, and when he thinks it's an easier sale if the consumer doesn't understand what he's buying.

MR. ATKINS: One last item, I'd like to encourage the NAIC to consider melding this regulation with the solicitation regulation so we don't have to send out a policy summary and an illustration at the same time.

MR. WILCOX: I agree.