RECORD OF SOCIETY OF ACTUARIES
1995 VOL. 21 NO. 1

# PRACTICAL ILLUSTRATIONS AND NONFORFEITURE VALUES

Moderator: WALTER A. NEEVES
Recorder: KEITH E. GANT

*Participants in this sessions will discuss alternatives for illustrations and nonforfeiture values and consider current practices and proposals for life insurance and annuities in the U.S., Canada, and overseas.*

MR. WALTER A. NEEVES: I am vice president and actuary with First Colony Life Insurance Company. With me is Keith Gant. Keith is assistant vice president at Southern Farm Bureau Life in Jackson, MS.

We have a lot of material to cover and I know all of you have opinions on these issues, and we want to generate input and ideas from you, the audience. For this meeting to be most effective, we need to focus on principles and guiding philosophies—ideas rather than specific details. On the life insurance side, there is the Life and Health Actuarial Task Force that's in the process of revising nonforfeiture law for life insurance, and this forum is designed to be an opportunity for all of us to have input into that process. In particular, the Life and Health Actuarial Task Force is looking for ideas and comments from the actuarial community on this topic. If anybody has a comment they'd like to make on nonforfeiture, that's a great place to start. One of the basic questions I think we can ask about nonforfeiture values for life insurance or annuities is, why do we need nonforfeiture values at all? What do we hope to accomplish by regulating minimum nonforfeiture values? I'd like to pose that question to you. Why do we need minimum nonforfeiture values at all?

MR. W. KEITH SLOAN: I have been a regulator and I say that at this stage, we need regulated nonforfeiture values. We don't need what has been proposed, and I was on the working group for about five years. The reason we need it is because we are not yet perceived as being sufficiently independent to be fair or equitable with our policyholders, without having at least some guidance. What we need is a law that says what forms of nonforfeiture values are acceptable and under what circumstances they are acceptable. At this stage, we probably still need a minimum basis of some sort.

MR. NEEVES: One of the things, I'm sure most of you are aware of, is that in Canada, the nonforfeiture regulations are quite different. A product that is available and sold in Canada today, commonly called Term to 100, doesn't have any nonforfeiture value at all. It's a level-premium, whole-life product without any nonforfeiture value. It's a product that we currently cannot sell in the U.S. I think a product like that brings a whole host of issues. Should we be able to sell a product like that here?

One of the issues that we confront with that sort of product, and I think that it's basic to nonforfeiture values and what we're trying to do, is the issue of equity, particularly equity between terminating and persisting policyholders. When we have a level premium whole life insurance product where we don't provide nonforfeiture values, some people make the argument that we're not treating terminating and persisting policyholders equitably. They say we charged the policyholders who terminate before maturity of the contract, or if they terminate at all in this sort of contract, then they've paid more than the life insurance protection they've received, more than the value of that protection. I'd like to suggest to the group, just as a topic for discussion, that we have some degree of inequity between terminating and persisting policyholders in every form of insurance that we sell today, and that we're not able to create perfect equity between terminating and persisting policyholders. As an example of this, I think we can look at the costs we all have for underwriting and issuing the life insurance policy, and there are many forms of life insurance where we don't charge nearly enough as a first-year premium to cover all of the issue costs, including underwriting and commissions. So right from day one we have a so-called "inequity" between a terminating policyholder and a persisting policyholder. We haven't charged enough in the first year and we're expecting to recover that shortfall from later years.

We have a degree of inequity, in that sense, between terminating and persisting policyholders from the beginning. One of the things we want this nonforfeiture law to do (and that's a topic for discussion here), is to address the question, how much do we want to impose equity between terminating and persisting policyholders?

MR. DOUGLAS C. DOLL: One of our problems is that we're not even sure, as a profession, what we mean by equity between persisting and terminating policyholders. I'd just like to give a brief update. At the March NAIC Actuarial Task Force meeting, Frank Dino, who now chairs that task force, asked the American Academy of Actuaries if they would come back to the NAIC with a proposal for what nonforfeiture might look like in the future, whereby minimum values would be defined by the pricing actuary, and that actuary would have to certify that the nonforfeiture values of that company's product meet certain standards of equity. The Academy then asked the Society of Actuaries to do some research on what equity might mean in that regard. The Society has set up a task force, chaired by Donna Claire, to investigate this issue.

The Unruh Committee, I believe, in the 1970s came up with a definition of equity for nonforfeiture, that the terminating policyholder should not leave the persisting policyholders in a worse position. Even that definition of equity perhaps is not necessarily the final word. There has been more than one definition of equity that's been proposed in the last few years and the Society task force will look at it. It's kind of interesting to think of the idea of equity as being something that can be researched. Perhaps there is no definite answer to that, but there is a task force that will address that issue.

MR. NEEVES: On the concept of equity, I mentioned a moment ago about the cost we have of issuing a policy. Another aspect of equity that we don't look at quite as much is the idea of antiselection upon lapse. If a good portion of the policyholders who are lapsing are healthy lives that are being underwritten for a new policy with another company, then we're losing good risks from the block of insurance and we have possibly a deterioration in mortality on the block from those healthy lives lapsing.

If you look at the cost of this and what you would need to charge the terminating policyholder in order to cover this cost, there will be higher mortality on the remaining block because the healthy lives left the block. If you impose a surrender charge on the terminating policyholders to cover the cost of the difference in mortality that they will cause the block to have, it's an increasing charge by duration. Obviously, at time zero they've been fully underwritten and their expected mortality is the same as the rest of the group. As you get into later durations, it becomes a bigger and bigger cost. If a healthy life is leaving the group, the difference between their mortality and the average expected mortality for the remaining block becomes bigger and bigger, and you get a surrender charge that would increase by duration if you were to impose this charge on terminating policyholders. It gets quite large as you get out to later durations. This is not anything like the typical pattern of surrender charges that we have on our policies today, and if we were going to attempt to impose perfect equity, then we'd need to consider that cost and that relationship between terminating and persisting policyholders, as well as some of the others that we typically look at. I don't know if any of you out there have looked at that particular issue or would care to comment on that.

I think that the issue of equity will be central to what we do with nonforfeiture values. The following is from the NAIC Life and Health Actuarial Task Force (the memo it was attached to is dated March 10, 1995) for the life nonforfeiture law of the basic premise is to provide minimum standard of return to policyholders and not discourage or reasonably restrict benefits or product design to the public, while maintaining basic equity and operating in a sound financial manner. The second premise is to regulate at the least restrictive level to obtain desired results. Does it sound like the kind of basic premise we should have for life insurance nonforfeiture values?

MR. SLOAN: I do like these basic principles. As a matter of fact, if you go back through the box or two of working group materials, you'll find I have been saying exactly the same thing for almost the last six years. These are the sorts of things that we need. As a matter of fact, I think the annuity nonforfeiture option was one that I proposed in the middle 1980s when I was a member of the actuarial task force, so I will say cheers for this. By the way, there are two states in which you can write whole life products without cash values as long as you have a comparable policy with cash values for those who feel they need them.

MR. NEEVES: Keith, on the proposed annuity nonforfeiture law, you're allowed to have an annuity without a cash-surrender value. I think a no-cash-surrender-value annuity is described in the draft quite well. One of the ideas that people have considered for life insurance is to have life insurance without a cash-surrender value, but a nonforfeiture value, either reduced, paid-up, or extended-term insurance, that would in some way make life insurance and annuity standard nonforfeiture a little bit closer. It seems to me that if we're allowed to have an annuity product without a cash-surrender value, we should be able to have a life insurance product without a cash-surrender value. I'm not sure why those two should be treated differently.

MR. SLOAN: Obviously, I think they shouldn't be treated differently because of the matter of equity. So often in the past eight or ten years, the purpose of a cash value has been to give an agent another first-year commission. That really doesn't help anybody but the agent, but the background of the annuity law comes with the original, standard nonforfeiture law for annuities. We had no idea when we put that together that we would be asked to do such a thing, but Teachers Insurance Annuity Association–College Retirement Equities Fund (TIAA-CREF) came through with so much political clout that they put a no-nonforfeiture annuity into the existing standard nonforfeiture law for annuities.

MR. MICHAEL E. DUBOIS: I think the questions of nonforfeiture values and equity do revolve around the disclosure. There have been a number of concerns expressed regarding two-tier products. Many of the people who are purchasing these vehicles, both the life insurance and the annuities, don't always understand what it is that they have purchased. We did some market research on the annuities we've issued, and we were surprised to find that many of our clients didn't realize it was an annuity they had purchased. One of the things we've got to realize with these nonforfeiture regulations is that this is a way, in some cases, to protect ourselves by putting these minimum values there, because if you sell an annuity or a life insurance policy with no cash value, that will not be one of the first things that the agent or the broker (or whomever is selling the product) will focus on. So you will be in a position where it could generate some negative concerns with the public, unless it is made fully aware that what they are buying is pure protection, or a life income at the end of the maturity period for an annuity. If you do not have some minimum regulation and take a look at this equity concern, the nonforfeiture values can tend to produce problems with the public in the future. That's not to say that some of the proposed regulations are perfect. Some of them have gone too far or are getting a little too close to rate regulation.

MS. SHERYL L. KALMAN: I think the big issue is disclosure, and I know we face that with our two-tier annuity, where the agent didn't want the disclosure. I think that any sort of a noncash-value annuity or life insurance almost needs to have some sort of mandatory disclosure statement that comes back to the company so it knows the agent disclosed the fact that there are no cash values. On the other hand, I think that if people are really buying protection on annuities, we can offer better products without cash value because we're not worried about the C3 risk.

MR. NEEVES: I agree. I think that's an excellent point. My personal comment is that disclosure is one of the key issues here, and we should work on the disclosure issue rather than the nonforfeiture issue. I guess a better way to say that is, we shouldn't attempt to solve the disclosure problem through nonforfeiture regulation. The nonforfeiture values, I think, need to be there to address whatever kind of equity concerns we have, and we need to address the disclosure issues separately. I don't think we can solve the disclosure issues through nonforfeiture regulation, and that probably ties us into what's happening on the sales illustration side.

As I mentioned earlier, the draft model regulation for sales illustration is attempting to address the disclosure issue. There is also a draft of the Actuarial Standard of Practice, which is also related to life insurance illustration disclosure. There are a number of issues that are covered by the model regulation and the Actuarial Standard of Practice. I'll run off a few key points first. On the NAIC model act, if a policy is sold with any illustration, the basic illustration must be prepared in accordance with the model. You can sell the life insurance product without any illustration.

There is the concept of the disciplined current scale, described in the model act. Perhaps many of you who have seen this are familiar with it, but there is a whole host of issues related to the disciplined current scale. There are a number of prohibited actions on sales illustrations, and I'll pick just a few. Vanishing premium terminology is listed as one of the prohibited actions. Lapse-supported pricing is one of the prohibited actions. Persistency bonus is another prohibited action.

On required numeric summaries, we have required guarantees, requirements for the disciplined current scale, and there is a third in there that's kind of interesting. It's sort of halfway between the guarantees and the disciplined current scale, and at the very least that poses some interesting calculation questions and difficulties.

Perhaps a point of controversy is the requirement for signatures of the applicant and the producer. It certainly adds a whole new wrinkle to the sales process, to get both of these required signatures. Also, if the policy is issued, a signed copy needs to be retained for three years, so there is a records management issue there as well. Perhaps the most significant issue here for most of us in this room is the concept of an illustration actuary appointed by the board of directors. The illustration actuary would need to make certifications, particularly regarding the disciplined current scale and the assumptions behind the disciplined current scale.

The Actuarial Standard of Practice relates to many of these same points and gives some guidance on what's involved in setting the disciplined current scale, in defining lapse-supported pricing, and some of those issues. I think a basic question we can ask about all this activity on sales illustrations is, will the illustration and disclosure requirements help the public and/or the insurance industry? Any comments on that?

MS. LINDA M. LANKOWSKI: I think any way that we can make illustrations more understandable to the public is certainly going to help us. We've seen the problems that have occurred when Senator Howard Metzenbaum (D–OH) was given an illustration with a vanishing premium, and he had absolutely no idea that he had bought a policy that was not paid up in four years. It caused many problems for the industry; it caused many problems because the press got involved, and the press doesn't understand the products as well as it thinks it does.

We have many problems with what is perceived rather than what is actual, and I think there are companies that have been creating those problems for the rest of us. Executive Life was doing some very strange illustrations as well as strange investment policies, and we have to do anything we can to stop that. I don't think that we need to go as far as England has and say—OK, you've got a completely uniform illustration—but I think it's about time our policyholders are given something they can actually look at and understand. They should be able to say, OK, I've got an illustration from Company A and an illustration from Company B. I understand the differences because I can look at them together and compare them. Today we don't have any kind of regulation that requires that. Company A can do it this way and Company B does it that way, and the policyholder or potential policyholder can't look at either one and make any degree of comparison between them. I think that comparisons are going on all the time, and I think this is something that we have to address.

Also, I would like to see something addressed with the idea of current scale being one that includes projections of mortality, or interest rate changes, and things of that sort. We're seeing those on the market today and these are things that supposedly can't happen because you can only illustrate current scale. Well, some have said, we've been seeing mortality improvement, so we're going to have the current scale have mortality improvements. It's not happening today, but it has been happening, and we project that into the future. I think this is wrong because there is no guarantee of those improvements. They're future improvements; they're not current mortality. I don't see that this model regulation has gone very far to change that, either.

MR. H. LEE MICHELSON: I think we need tighter disclosure requirements on illustrations and that the concept of having an illustration actuary sign on the disclosures is a good one. However, I think that some of the details of this proposal go beyond the question of disclosure, to requiring pricing exercises that amount almost to a whole second pricing of the product that serve no purpose except compliance with the illustration regulation. I think we'd like to avoid that. I don't know any way to produce a disciplined current scale of dividends without a management decision on exactly how to time changes in the dividend scale to reflect changing experience. You might say, the illustration actuary should price a disciplined scale for illustration purposes, but that's a phantom scale that management may or may not ever adopt. I don't see that it discloses anything to the customer receiving the illustration that's of value, and it's a whole repricing of the product just to comply with the regulation.

What I think would be reasonable from the point of view of discipline is pointing out to the policyholder what factors may make the dividend scale not sustainable. This would require certain disclosures that are required now on the annual statement schedule and interrogatories. The illustration could include the illustration actuary's signature. These would provide a warning to the policyholder where the scale is not disciplined, but I think to require actually developing a scale that is disciplined is a lot of work that serves no purpose. I think the same thing is true, although I don't have such a specific recommendation for a remedy, with the concept of lapse supporting. A reasonable pricing actuary will price at a realistic lapse assumption and do some sensitivity testing. But forbidding the illustration of a policy that's lapse supported seems to have nothing to do with disclosure, but rather to be just a matter of rate regulation. Saying that one may not sell (at least with an illustration) any policy that doesn't produce acceptable profit results with zero lapse, may not be a reasonable scenario in the actuary's opinion even with sensitivity testing.

Every policy, I think, has some degree of lapse support, because you can't cover your first-year expenses in the first year, and I don't think a prohibition of lapse-supported policies would be enforced in any realistic way or would serve a purpose. But I do think that we need some better disclosure to cover particular abuses when a persistency bonus involves a higher interest rate, either retroactively or not, that was input solely for comparison with other companies. Then there is some misleading information in the policy. If the policy involves a mixture of interest rates, then that should have to be disclosed in the heading with equal prominence with the initial interest rate. I think we need some tightening of regulations against misleading labels on the policy, but I think you'd drive off the market a lot of policies that are not abusive at all if you tried to enforce prohibition altogether of lapse-supported policies.

MR. DAVID G. WHITTEMORE: I just want to respond to the last two speakers. I've been involved somewhat with the Actuarial Standards Board (ASB) in developing this Actuarial Standard of Practice. First of all, the first comment was about not being able to project future improvements in mortality. There is a prohibition of such action taking place in trying to demonstrate compliance with the model law and with the Actuarial Standards of Practice.

The issue of lapse-supported pricing has become more clouded lately. There was a prohibition initially of lapse-supported products. I guess it might still be in there. The ASB developed a test for that which was to compare an asset share to the projected cash values at various points in time with a zero-lapse rate beginning in the sixth year and later. Quite frankly, that test wasn't particularly successful at weeding out any products that obviously had some fairly rapid cliff increases in illustrations. So in the latest drafts of the model illustration, additional steps have been taken to try to get to those products with the rapidly increasing cash values. What they've done now is to define what persistency bonuses are. Up to this point, there really had been little definition of these concepts, but the latest draft prohibits persistency bonuses by defining a relationship that must exist throughout the duration of the contract. And this relationship is that the cash value in one year divided by the asset share in that year, can't increase by more than two percent to the next year. I think that particular definition of persistency bonus is going to be one of the strongest features of this model law and will probably impact up to 50% of the products out there today.

MR. JUSTIN N. HORNBURG: Upon reading the model regulation, I think it's going to do an awful lot to educate the consumers as to exactly what it is they're buying. I think in a theoretical way that's a very good thing and in a practical way, also. However, I wonder if anybody has thought about, in their own company or just in general, what the effect on sales of life insurance policies will be. We hear a lot about, "we did some market research and we found that this percent of our policyholders didn't know what it was buying." This model regulation will go a long way toward making sure that people do indeed know what they're buying, and I'm just wondering if anybody's thought about, if they know what they're about to buy, how many of them will still buy it?

MR. MARK J. GREENE: I'd like to take that one step further. What I noticed was there is a requirement for in-force illustrations, and people may have thought they bought one thing and whenever you have to give them an in-force illustration with a current disciplined scale, they're going to realize they bought something else. I think many companies will have serious problems with policyholder retention.

MS. LANKOWSKI: I happen to think that, in general, people are smarter than we seem to think they are. They really do understand that they're buying a product from a life insurance company. When they get Met, it pays. They understand that that's a life insurance company or it's an insurance company of some kind. They're buying insurance. If we have an illustration that has both guarantees on it and illustrated values, and each year we start showing them more illustrated values, they will get the idea that this is something they should pay attention to or they will say, "I don't care, it's just another piece of paper, I'm throwing it away." I don't think they will stop buying our policies. I don't think they will suddenly start lapsing policies. I think that they're going to pay just about the same amount of attention to their policies as they are currently. I think the only thing the illustration signature will do is to cover us when their lawyers come at us. I think it will cause extra paper that we have to hold on to and will be a real pain in the neck. The records retention people will go crazy. They will think it's great because they'll get a whole lot more revenue from the insurance companies, but I think consumers are smarter than we think. I know there are a lot of people out there who understand they're buying a life insurance contract. They also understand that there is an investment element to that. We have emphasized that aspect more than we have the life insurance portion, but I think most of those people really do understand what it is they're buying.

MR. HORNBURG: I'd like to know if that includes people who bought policies under the assumption of vanishing premiums and whether Senator Metzenbaum really knew what he was buying. And if we can't illustrate vanishing premiums any more, how much is that going to affect sales? I'm not necessarily arguing that consumers are stupid or that people don't really know what they're buying. However, I hear a lot of reports that we asked the people what they bought and they didn't know. I think that maybe the person who buys a $25,000 life insurance policy and just needs coverage is one thing, but I'm curious about people who buy higher face amount policies with vanishing-premium illustrations. I'm not necessarily saying that people are stupid, but I just want to know what people think.

MR. NEEVES: I think they're all good points. One thing I would like to clarify and David, maybe you can help me on this. On vanishing premium, I think what's prohibited is the terminology, using the "vanish" word. David, can you clarify that?

MR. WHITTEMORE: I think that is the proper interpretation. The model law provides for a base illustration and also allows for supplemental illustrations. As I interpret it, a base illustration would, in essence, show the contract premium on a continuous paid basis throughout the whole contract. You can illustrate a vanishing premium scenario as a supplemental illustration. It has to follow all the same rules as the base illustration, as far as supportability, not being lapse supported and the like, but for some reason they have actually banned the terminology, vanished premium, or anything along those lines.

MR. SLOAN: The vanishing-premium concept has been with us since the beginning of the century. I've seen illustrations of policies in companies that were formed about that time and had things that we sometimes call charter policies, and coupon policies, for example. One company I know routinely sold a coupon policy, 20-pay, with the coupons cancelled, which made it a 14-pay. That's a vanishing premium. This was brought out, I think, in 1914, so it's not a new concept, but I'd like to point out one other real problem, and that's that most of these illustrations are not made up in the home office—they're produced on laptops in the field. Regardless of how disciplined the scale is that you put into the agent's laptop, if he can change it or, as in one instance that I have seen, if he is trying to show a loan-supported policy and doesn't recognize that with a variable loan rate when the interest rate changes on the loan, it's also going to change on the dividends, somebody is in trouble. As a matter of fact, somebody was in trouble and they lost a lawsuit on that.

MR. MICHELSON: I think that requiring the policyholder's signature does serve a purpose, which is not legal coverage for the company, of allowing the home office to know that the policyholder has received the last page of the illustration that contains the required disclosures. I have no way of knowing that now. Usually when I get a question about an illustration, what comes back to me doesn't have the notes on it, and I have no way of knowing if the policyholder actually got them.

MS. SUSAN OBERMAN SMITH: I think that one problem, even with the illustration disclosure, is that you are still not controlling what the agent actually says to the client, even when he or she sees that illustration. I've been in many situations where our agent says, "I sold them a ten-pay contract and it was paid up in ten years," and I say, "It's not paid up." I don't know how you can handle the idea of the agent telling somebody that it's a paid-up contract when it really was a vanishing-premium-concept contract.

Another point with disclosure, we were just in a case where we have many of our agents saying that our illustrations are little mini-booklets, because we have so many pages of footnotes. And we lost a case to another company because our illustration said "this dividend scale is not guaranteed and may not be paid at this rate," and another company's didn't. He said, "I understand neither is guaranteed, but yours sure sounds like it's going down faster than somebody else's." So I think if we had similar wording, then we wouldn't run into that problem.

MR. KEVIN A. MARTI: I'm with a smaller stock, life insurance company. I have a couple of concerns regarding the disciplined current scale. Is a mutual company's current dividend scale necessarily a disciplined current scale? I'd be interested in anybody's thoughts on that. What I'm thinking about in particular is, universal life companies, back in the early 1980s, were illustrating interest rates that we all knew were not realistic long term. If a mutual company's portfolio dividend interest rate is 9% and we're sitting in a 7% interest environment, is that really a disciplined current scale? That's one question.

My second question goes to the macro-pricing-type idea, which is that a smaller company may or may not be able to price for its full overhead expenses in developing a policy. To price for its full overhead expenses may mean that it develop a product that generates no sales, and no sales means no profits, which means no overhead expense coverage. I'm interested in the thoughts of the consulting people who helped develop many of the products for smaller insurance companies as to whether smaller insurance companies really can or do currently price for full overhead expenses in their product development.

MR. NEEVES: I think they are both excellent points. I don't know if there are any people here with mutual company backgrounds that want to respond to the first point.

MR. WHITTEMORE: I'll try. First of all, the current payable scale may indeed not be a disciplined current scale. One point Mark Greene brought up about policyholders buying policies; now they get a new illustration that shows that what they bought isn't what actually happens under the new regulation. The regulation is applicable only as stated in the model law, only applicable to new business issued after the effective date.

I'm trying to address the 9% and 7% issue. The disciplined current scale will be a disciplined current scale if it meets this solvency test and is prudently non-lapse supported. So the fact that the dividend scale was at a 9% rate, if based on current experience of the company, maybe its portfolio rate is 8%, and maybe it has had improved mortality. If it can demonstrate that the illustration that's generated can satisfy the solvency test, based on today's experiences, then it's still a disciplined current scale.

MR. MARTI: Do you think, in general, that a currently declared scale of a mutual company would be considered a disciplined current scale?

MR. WHITTEMORE: I think the mutual companies' dividend scales are under every bit as much attack as the stock lives credited. While we're on the mutual topic, I'll just open something else up that does, I think, involve or may generate some comments from the mutuals, and that is the treatment of terminal dividends.

Up until recently there has been somewhat of a feeling on the individual committees dealing with the subject from the ASB and the NAIC, which have sort of passed their grace and said, terminal dividends will still be allowed. That's been the desire of the committees. However, with this definition of persistency bonus, where cash values can't increase but by fairly small increments, that, in effect, will remove terminal dividends from illustrations or at least really limit them. I think the terminal dividend issue is likely to be debated fairly heavily, but under the current wording, those are out.

MR. MARTI: Could you talk about the expense question for smaller companies?

MR. WHITTEMORE: I think a little interpretation of the standards would say that you can't use macro-pricing for sure. There are some provisions in the standard that will allow you to amortize some development expenses, development of systems over a period of years, but under the current wording, (and I'm not sitting on these committees so I don't know the discussions going on, maybe there is somebody else here who is,) but I think the current wording does require full allocation of all expenses, based on an acceptable, defendable allocation procedure.

MR. MARTI: Would you agree that most small companies do not practice that discipline?

MR. WHITTEMORE: I don't have a comment. I don't think so. Doug, do you have a comment on that one?

MR. DOLL: I'm not sure, but what's your definition of most?

MR. MARTI: . . . to only policies issued after the effective date. . .

MR. WHITTEMORE: What does the effective date say on the model regulation?

MR. MARTI: It says the model regulation is effective one year after date of adoption, but it's not restricted to policies issued after date of adoption. It says all policies.

MR. WHITTEMORE: According to this copy, Section 18, "the regulations shall become effective and shall apply to policies sold on or after the effective date." This particular draft is new (it came out mid-March), so there may be conflicting provisions.

MR. GREENE: If somebody asks for a re-proposal on policies sold prior to the effective date, what do you show them?

MR. WHITTEMORE: A re-proposal, or to buy a new policy?

MR. GREENE: An in-force illustration for a policy, say, sold in 1994.

MR. WHITTEMORE: Mark, I can't answer that, but it sounds to me like it means you can continue on with the same practice existing on the in-force product that you have at the time the policy was issued. That is what it sounds like to me.

FROM THE FLOOR: So you give two illustrations.

MR. WHITTEMORE: Could be. If you need to do that, then it may be a problem anyway, I don't know. That could also be something that's hashed out—this hasn't been exposed yet for discussion. All these types of things are good questions that need to be addressed at that time.

MR. ROBERT A. MARKS: I wanted to see if I could stimulate some discussion with regard to vanishing premium. Most of the negative responses I've heard are the result of the fact that most vanishing-premium illustrations are geared toward current illustrations. What about the possibility of having the counterpart-guaranteed-vanishing premium? Of course, under the current guideline premium rules, it may be just a theoretical exercise and may not be able to be put into practice, but that's another issue, whether the guideline premium limitation rules are really dynamic enough to withstand low interest rates.

MR. NEEVES: Anybody else? We've got a lot of talent here and I think there are a lot of issues we need to talk about.

MR. NOAM SEGAL: I'm not sure if this is addressed in the draft, but I'm curious. Something that always bothered me in the illustrations was that the tax implications on loans aren't apparent on an illustration, vis-a-vis if somebody surrenders a policy and has been taking out loans and is building up this cash value, I'm just wondering if maybe that should somehow be included. It's just one of those anomalies in insurance, and when somebody learns of it, they're always kind of surprised that there is this taxable event, equivalent to borrowing on your 401(k) or whatever it is.

MR. NEEVES: I think that's a good point, and it probably points to another area of disclosure, that there are a whole host of tax issues that we certainly don't fully disclose on the illustrations. I don't know how far any of us want to get into tax disclosure on illustrations, but that's an excellent point.

MR. PETER T. LECLAIR: I have a question about Section 14, having to do with in-force illustrations and annual reports. The model seems to be saying, in the case of a policy designated as one for which illustrations will be used, the insurer shall provide an annual report on the status of the policy, etc. I'm not sure what types of policies would be so designated. Can anybody help me with that?

MR. NEEVES: I think earlier in the draft it's mentioned that you can sell a policy without an illustration. You're not required to provide an illustration. I think here we're distinguishing between a policy that's sold without any illustration at all and a policy that was sold with an illustration that complies with this draft. So there are two types—one is the type that didn't have an illustration at all. That's the way that I interpret that.

MR. ALAN F. HINKLE: I see that in the draft regulation, as I believe it has been in several drafts. The regulation applies to all life insurance, except variable life and in the ASB standard. That standard applies to policies covered by the NAIC regulation. I understood that either at the NAIC level or at least at the ASB level there would be some comparable regulations or guidance forthcoming for variable life. I'd be interested to hear from anyone who could comment on that.

MR. WHITTEMORE: Actually, I don't have the specifics on that, but just a quick background. The original NAIC model law included variable life products. Somewhere along the line there became a concern that there would be some conflicts between SEC requirements and the intent of the model regulation. The NAIC didn't want to get into a jurisdictional battle at this point, so it decided to exclude the variable life contracts. However, it is my understanding that the NAIC has every intention of developing a variable life model regulation along these same lines, tailored for the specific situation, and also something along the same lines for illustrating annuities.

MR. HINKLE: Will that be a model regulation at the NAIC level or just actuarial standards?

MR. WHITTEMORE: It's the NAIC, certainly, that's driving all this. The ASB is responding and it's the NAIC's intent to do that.

MR. HINKLE: Do you have any idea what the timetable is for either this first one or the follow-up?

MR. WHITTEMORE: The NAIC, I believe, would like to have its model regulation adopted by the Life Subcommittee A, perhaps in September. The ASB committees that are working on this standard have passed out a ballot to determine whether they would recommend this to the full ASB board. I think they want to distribute it in May and get comments back from the industry by July, so that's on a fairly fast track. They're both on fast tracks at the moment. The earliest that this thing is likely to actually impact anyone is probably 1997.

MR. D. LEIGH HARRINGTON: I'm an actuary for what you would no doubt define as a small insurance company, and I'm fighting the constant battle that was referenced earlier as far as trying to cover overhead expenses and still have a product portfolio that is reasonably competitive. I note that quite often here some of these drafts had expense limitations in the nonforfeiture law, and I think our products, some of them, certainly run up against those. And I'm wondering whether that will continue to be a tract in the second, standard nonforfeiture law, and how close it is to becoming a reality if that is the case?

MR. NEEVES: On the life insurance nonforfeiture law, they're sort of back to square one. There are basic principles that you have in front of you, and the life and health actuarial task force is working on basic principles. There isn't a current draft of this second, standard nonforfeiture law for life insurance. That's my understanding. The proposed draft of the annuity nonforfeiture law includes what you might call expense limitations for annuities, and that's quite close, if that answers your question.

MR. HARRINGTON: Did you say that there's not a draft standard nonforfeiture law?

MR. NEEVES: For life insurance, it's back to square one. They're back to basic principles, and the life and health actuarial task force is into basic principles. There have been drafts, but there isn't a current draft that's being proposed for adoption. That's my understanding.

MR. HARRINGTON: OK, they're going back to basic principles. Is it very difficult to say, is there likely to be a continued focus on them and expense charges? We have the expense charges already limited in a low-interest-rate environment, and they run up against your guarantees.

MR. NEEVES: With regard to what they might do on the second, standard nonforfeiture law for life insurance, it would just be speculation on my part. I think that it's fairly wide open. I think there is a question of whether we'll have a retrospective type of calculation that would include these so-called expense charge limits or a prospective calculation that wouldn't limit expenses quite as directly. I think it's even that wide open.

MR. DUBOIS: I have several comments on the proposed standard nonforfeiture law for deferred annuities. I'll start off with the expenses. One of the things that I've noticed in reviewing the drafts as I've been going along, and have made some comments to the NAIC myself, is the expense limitation. I believe currently they're limiting the administrative charge to a flat level $40 with no indexing. One of the concerns that I have there is that if you compare that with the level of expenses allowed under the current model DA regulation, or for those companies following the not-so-widely adopted model MVA regulation, this is actually a reduction in the expense level that would be allowed when you consider the indexing from, I believe, June 1973 to present, versus the $30 that was in those two model regulations. I'm very concerned about this $40 limit and the fact that it's not indexed. In some studies we've done recently, looking at various third-party administrators for the cost of administering a policy, their charges plus taking account of postage and mailing and such can put the cost of administering a policy somewhere up in the $50 to $60 range. This means that if you want to try to match your expenses to your charges, the $40 limit creates a bit of a problem, in addition to the fact that some existing contracts using a current and guaranteed structure, may have guarantees that are in excess of the $40 that will be in the new nonforfeiture law.

Additionally, a couple of other things have come through. In general, the nonforfeiture law as proposed has a number of good points. It brings all of the various types of annuities under one umbrella as opposed to three different model regulations. Using the reduced interest rate of 2.5% as opposed to 3%, is a good thing in the environments we've seen, but there are some disturbing things in the latest round. With respect to the market-value adjustments, the limitation to 25% up or down from the current account value takes away some of the risk savings that you get from using an MVA. I know there have been a number of concerns expressed about that because it makes the asset/liability management associated with an MVA product a little more difficult. Additionally, with regard to the death benefits that are mentioned in the nonforfeiture regulation, with the guaranteed minimum death benefits that are now very popular on the market for variable annuities, we may potentially see a situation where there will be nonforfeiture values required for some of these death benefits because they are in excess of what would be considered incidental to the annuity contract under the nonforfeiture regulation. I would be interested in any thoughts on this topic.

MR. NEEVES: I'm not sure if I understood correctly. With regard to the expense charges on annuities, the indexing of expense charges I think has been in and out of various drafts. The draft that we have now, the one dated March 7, indexes the $40. It gets multiplied by the ratio of the Consumer Price Index. I'm not sure if I understood you correctly. I think that the $40 is indexed on the current draft.

MR. DUBOIS: I'm not able to see that particular item. I do see the indexing in there, and I know it was in there for the transfer charge in the December draft, but at least as of December, the $40 was not an indexed quantity. If they have changed that so that it is at least now indexed from June 1993 forward, I think that is a good change and one that is needed because expenses continue to rise. Most of the administrative cost is salary based, and salaries are increasing with time. I'm still concerned that you have a disjuncture between the model variable annuity regulation as it stands today, which does have a much higher limit. It would allow as high as a $60 charge for an administrative fee versus where we'd be starting today with somewhere, probably around a $40 to a $42 level with the CPI indexing.

MR. THOMAS NEAL TAYLOR: I'd like to ask how we can judge whether our scales, our nonguaranteed elements in a life product, are disciplined. For example, if under aggressive assumptions in the pricing process they meet company profit objectives, but under more disciplined assumptions they don't lose money, just make less, would that count as disciplined or what might be the test?

MR. NEEVES: I think they're good questions, and from my understanding of the disciplined current scale, I don't think anyone is trying to regulate the level of profit. When we look at how the disciplined current scale is defined, I think it allows for a broad range in company profit targets. I don't think there is any objective there to define how much profit a company should make, so I think the answer to your question would be, it would be acceptable to have a disciplined current scale that was at a low profit level.