RECORD OF SOCIETY OF ACTUARIES
1995 VOL. 21 NO. 4A

SALES ILLUSTRATIONS

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Several panelists will debate the need for and the current design of the regulation and standard of practice (SOP) for sales illustrations.

MR. TIMOTHY F. HARRIS: We're going to try to raise a few controversial issues and have them addressed by the panel as we go along. We're going to begin by presenting some of the groundwork. Tom Foley, who was the vice-chair of the Life Disclosure Working Group and who is currently with the North Dakota insurance department, will present the background for the NAIC's sales illustration regulation. Tom will tell us when it is going to come out. Tom has been in the insurance industry for 20 years and a regulator for the last four years.

MR. THOMAS C. FOLEY: The proposed model regulation is applicable to individual and group life insurance, but it is not applicable to variable life, annuities, credit insurance, and policies with face amounts of $10,000 or less.

The disciplined current scale deals with nonguaranteed elements and is based on recent historic experience. The illustration actuary has to certify, at least annually, that the disciplined current scale is the basis for the scale to be illustrated.

The three illustrations defined in the model are basic, supplemental, and in force. A basic illustration is the standard one that we're accustomed to providing to applicants. Supplemental illustrations are for specific situations like keyman and business insurance. The disciplined current scale must be used in supplemental illustrations and in basic illustrations. The policyholder can request an in-force illustration.

The illustration actuary must be appointed by the board of directors. This is something that we developed in order to give the actuary some real clout when the president, the accounting officer, the marketing officer, and the actuary are in a room trying to decide what is to be illustrated. In the past, the marketing officer has often been the one put in charge in this situation.

The illustration actuary reports directly to the board and has to make a certification annually. A company may have more than one illustration actuary.

The self-supporting requirement mandates that the accumulated cash flows under a policy from year 15 on (year 20 on for second-to-die policies) must not be less than the total value that is available to the policyholder.

The Actuarial Standard of Practice (ASP) defined a lapse-supported illustration. This uses the same assumptions as the self-supported test only persistency is 100% from year five on.

Until recently the assumption was that the disciplined current scale would only allow for fully allocated expenses. The model and the ASP provide three choices for the disciplined current scale with regard to expenses. One option is to fully allocate expenses. The insurer can also choose marginal expenses or a generally recognized expense table. We're also developing an industry expense table.

A company can determine, for each policy form, whether it is to be illustrated or not. If it is illustrated, all policies sold under that policy form have to be sold with an illustration. If the insurer chooses not to illustrate a given policy form, then no policy sold with that form can use a sales illustration.

The illustration scale can't be more favorable than the minimum of the discipline current scale which is defined in the ASP and what the company's currently paying. The term vanish or vanishing premium can not be used.

The preparation date and number of pages must be shown. The guaranteed values must be shown before the nonguaranteed values. There must also be a narrative summary, a numeric summary, a signature and date on statements, and tabular detail.

The narrative summary requires that there be a brief description of the policy. For example, you could say this is a universal life policy; the annual premium or the contract premium is $600 and the face amount is x. Then you must define any riders. In lieu of the fixed format for illustrations (which was contemplated), certain sections have to be included in a sales illustration. In addition to the narrative summary, the numeric summary is required which shows at durations 5, 10, 20, and age 70, policy guarantees, the illustrated scale, and a midpoint scale. It also tells in what year coverage ceases on each basis.

There are a significant number of regulators and others who are concerned that the illustrated scale is to be projected 20, 30, 40, or 50 years in the future. There was much discussion about grading, after a certain number of years, into a set interest rate.

The sales illustration has to be signed by the applicant and/or owner depending on the situation, and it has to be signed by the producer. Basically the producer is signing that he or she hasn't said that nonguaranteed elements are guaranteed.

Tabular detail generally shows what has been provided historically. Supplemental illustrations must be accompanied by a basic illustration and the disciplined current scale must be used. Guarantees are in the basic illustration, so they don't have to be in the supplementary illustration. If they are not, the supplemental illustration clearly needs to point to the guarantees that are in the basic illustration.

The owner must be given an illustration at the point of application, if possible. In all cases, the owner must have an illustration that matches the issued policy and it must be signed by the producer.

With regard to the actuarial certifications, at least annually, the illustration actuary for that policy form or policy forms must certify to the board and to regulators that the disciplined current scale was used or that the illustrated scale wasn't greater than the disciplined current scale. A responsible officer also has to authorize that the illustrations were in compliance. The actuary is going to certify about the disciplined current scale, and an authorized officer of the company is going to certify that all other aspects of the sales illustration model have been satisfied.

MR. HARRIS: Daphne Bartlett from the California Department of Insurance is here. I think Daphne may have some differing opinions.

MS. DAPHNE D. BARTLETT: I'm a member of the NAIC working group that developed this regulation and I am terribly disappointed. I have been interested in the illustration issue for probably 15 or 20 years, and some of you may know that when I became President of the SOA, the first thing I did was establish the task force that developed the report on sales illustrations. Tragically, what's come out of this process doesn't do the job. Two weeks ago in the *National Underwriter*, there was a report of the working group's meeting in Philadelphia, and on the same page was a writeup about an agent who had won a very large amount of money from his company. Apparently, he never understood about "vanish" illustrations and got into trouble with his clients. All of this, of course, happened during the 1980s when illustrations were presented using the high interest rates at the time. They all fell apart because interest rates went down. Now interest rates didn't go down because actuaries were being aggressive. Interest rates went down because they went down; actuaries had nothing to do with it. Policyholders were disappointed, because you'd much rather believe that you will receive the $5 million shown in the bottom right-hand corner of the illustration than perhaps a more realistic number.

Illustrations, prior to this new regulation, have disclaimers on them that say the numbers are not guaranteed. Now, think about what would happen if this regulation had been in effect ten years ago. The same article would be appearing in *The National Underwriter*. Maybe it wouldn't have used the word "vanish," but it might have used "disappearing" or any other word you can think of that means the same thing. I think that the NAIC group has labored very hard and come forth with nothing much, but I think we had an opportunity. At this time, interest rates are at somewhat of a manageable level, they aren't at the 12–14% level that existed in the mid-1980s. We'll all be gone when interest rates get up to that level again. When they start to go down again, it will be proven that this regulation doesn't work.

I think it's probably too late for anything to be done, but I wonder why there is such a rush. We can do a better job. We can prepare a regulation that addresses life insurance annuities and variable products all in one, and I think there are many possibilities to redefine what an illustration is and what it should contain. Illustrations do not have to be current scale or disciplined current scale forever. Can you think of anything else that is represented as continuing the status quo forever? I think that there are ways that we could develop a regulation that would keep all companies on a level playing field so that nobody would be unfairly advantaged or disadvantaged, and would benefit the consumer and achieve the real objective of this regulation which is to not mislead.

MR. HARRIS: Before we continue with our speakers, I'd like to take any questions or comments on Tom's presentation and Daphne's comments.

MR. HOWARD H. KAYTON: Is this applicable to policies issued prior to the effective date of the regulation?

MR. FOLEY: No.

MR. ROBERT W. FIELD: I have several questions. In defining a self-supporting scale, do the cash flows have to just break even or do they have to provide a normal pricing profit margin? Second, if you're backing part of your product reserves with common stocks, how do you determine the earned interest rate on that? Do you take into consideration capital gains? How do you handle fluctuations from one year to the next?

MR. FOLEY: Frank, do you want to speak on that? Frank Irish from the Actuarial Standards Board (ASB) is intimately involved in developing the ASP.

MR. FRANK S. IRISH: Tom gave me a lead in here by describing this as a compromise. It certainly is a compromise. In answer to your first question, I think any hard-nosed regulation would have required the cost of capital or some kind of profit margin to be assumed in making up illustrations. However, due to the number of requests received from the profession that great flexibility in making assumptions and illustrations would be desired, it was finally decided that one way to achieve that would be essentially to require the actuary to assume at least a zero profit margin. It gives you room to do other things that you might want to do; for example, you can market one policy form at a low profit margin and another at a high profit margin. It gives those companies who want some room to move on expenses a chance to do that. I can't describe it in any more favorable terms than it's a compromise.

Your second question had to do with liability supported by common stocks. I hope that the language in the ASP provides for recent historical experience. It provides for the use of the actuary's judgment in terms of whether that experience is credible, and if not, what is credible. It provides, in at least very broad terms or very fleeting wording, the smoothing of capital gains because it provides that the company may make a capital gains assumption in its illustration work that is similar to the way it assigns capital gains in its pricing of work. We assume that the typical company will be smoothing capital gains, and will be able to do that in deriving its interest assumption that underlies the disciplined current scale.

MR. HARRIS: Frank, would you like to make any other comments about the upcoming ASP?

MR. IRISH: I have been in the position for the past year-and-a-half of having to make comments (not voluntarily) or answer many questions on the spot. I could comment on any number of things, but I will comment on the relationship between the ASB and the NAIC and the parallel relationship between the standard and the regulation.

As Tom said, it was just about a year ago that there was this substantial body of opinion that this regulation should require guarantees only but what would that have done? There was another substantial body of opinion, that was perhaps even more powerful, that we should illustrate past payments only. Similar to mutual funds, we could illustrate what had happened in the past, what we actually paid as dividends in the past, but nothing more. There was much work that had to be done.

The ASB worked in parallel with the NAIC and with the industry advisory group to develop the concept from that very rudimentary beginning. It was a cooperative effort. The ASB did not attempt to take the profession off into a corner and pretend that it had no relationship to the NAIC. It was the NAIC who wanted and who were under pressure to develop a regulation on sales illustrations. I think the profession and the industry would also feel themselves under pressure to develop some kind of regulation on this subject that has been a matter of abuse for more years than I care to name. The ASB has little power to develop practice methods that are substantially different from what is going on.

Generally, the ASB tries to limit itself to today's practice, or in some cases, to the best of today's practices. Clearly, what went into this regulation was something that was substantially different than today's practices in order to impose some kind of control on the situation. The 15-year rule on self supporting, the 5-year rule on lapse supported, and 100% persistency test—the three-way choice of expenses and many other items—are in the regulation. They could not have been in the standard alone, they would have been too radical. We would have been subject to antitrust action had we tried to develop that in the profession alone; they had to be in the regulation. They got into the regulation because the NAIC and the ASB and the industry advisory committee worked closely together to develop them to the point where they were more or less satisfactory to all parties concerned. I feel there's a great deal of misunderstanding about the powers of the ASB. They aren't as unlimited as many people think.

MR. HARRIS: We'll move on with our panel. We're going to have Kevin Marti make a presentation from the viewpoint of a small-company actuary. Kevin is also a member of the Small Company Section Council. He's presently vice president of administration and chief actuary for Westfield Life Insurance Company. Kevin is a graduate of Ball State University.

MR. KEVIN A. MARTI: My perspective is from that of a smaller company actuary, both for the last seven years as the chief actuary at Westfield Life, as well as for six years prior to that working in the consulting environment with small companies. I have a number of concerns about the regulation as proposed, particularly as it relates to small companies. I think there are many good ideas in the proposed regulation, although there are a number that will add to the time and expense of doing business, and that's not something that I look forward to as a small company actuary. But I kept trying to think back to how we got to this point; what caused us to need this regulation? I'd like to go over what I consider some major concerns. I started out by writing this for small companies, but I believe the concerns are applicable to all companies when it's all said and done.

My first and foremost concern would be the expense allocation requirements. Tom has already gone over the three types, so I'm not going to spend a great deal of time describing them. Suffice it to say, though, that if the fully allocated expense method was required, I don't think most small companies could afford to use it and still be competitive. Marginal expenses, that is, where companies don't allocate indirect overhead expenses (a macro-pricing-type approach perhaps), will not be allowed unless they're greater than the "generally recognized" expense table, which is the third option. The generally recognized table is based on industry averages that the industry is to propose to the NAIC.

However, the regulation, as written, states that if the industry cannot agree on a generally recognized expense table, we'll just fall back to use of fully allocated expenses, which would be a wonderful proposition! Small companies would basically be out of business at that point, because if you can't illustrate it, I don't believe you can sell it. While I appreciate Tom's comments about pricing and illustrating, from my perspective, it's hard to separate the two.

It's important to note also that this expense allocation requirement is a choice that has to be made in aggregate for all policy forms. For example, if you're in a small company, and you feel you need a particular product to stay in the market with your agents, you can't shave your expenses on that one product in order to attract agents or stay in the market with your agency plant by using different expense levels on the other products. I think a great number of actuaries have embraced macro pricing. It has even been described as a generally accepted actuarial practice methodology by some prominent actuaries. In my opinion, to not allow illustration of products developed on this premise looks and smells very similar to "price fixing." We could ask any number of reinsurers in this room how often they have had the luxury of using full expense allocations in their pricing. I think you'd find out that they can't do so very often. Furthermore, the required disclosure of the expense allocation method chosen on the illustration can be utilized by agents in competitive situations to an even greater extent than some of the size and financial ratings comparisons that have been used against smaller companies in the past.

I'm disappointed that the NAIC and the ASB have reached this point. When I read the program information, I was struck by the antitrust disclaimer that we have at the front of the program. I want to read that disclaimer to you. It says, "Under no circumstances shall meetings or programs be used as a forum for representatives of competing companies and/or firms to reach any understanding whatsoever either about the pricing of specific products, whether particular products should be marketed to the public, or terms on which products are marketed." That sounds to me like some of the things that are built into and implicit in the illustration model regulation.

The second point I wanted to talk about was seeing the inconsistency with GAAP treatment of overhead. I think overhead expenses go straight to the bottom line in the "GAAPing" process. Overhead is also not an issue for recoverability. The issue is how to deal with different tax situations or different organizational structures. There can be very sound business reasons for allocating more or less expense to a subsidiary in a given year. I guess I just don't understand the expense requirement as written.

The third point is, what if the disciplined current scale becomes undisciplined? For example, market conduct publicity last year caused the sales at several pretty well-known companies to drop something on the order of 30%. Does this mean the company must lower their disciplined current scale and exacerbate their sales problem, or must they go through and cut their expenses by 30%? In the disciplined current scale, no projected improvements are allowed. Again, to me this smells like price fixing. If companies want to bet on continuation of future mortality improvements, that's their business. It's not something I'm comfortable with, but that's their business. We are in the risk-taking business. In many cases, the resulting premium rates that they're developing are being guaranteed for 10 and 20 years. That's the frightening aspect.

The fourth consideration relates to the portfolio versus new money rate situation. Much of the current clamor for illustration reform is a direct result of the decreasing interest rates in the 1980s, and the resulting impact that decrease had on universal life and portfolio dividend type illustrations, for example, the "vanishing" premiums that didn't vanish or that reappeared. How can the NAIC sanction portfolio-based product illustrations at 8% or more when new money interest rates on most quality investments are 100 or 200 basis points less today and will continue to be for the foreseeable future? Potential policyholders are being misled if available investment rates remain at current levels. While I appreciate the earlier comment that there was an attempt to grade to a uniform conservative interest rate after five years, apparently this idea was rejected by the NAIC's committee. If one of the goals of the regulation was to ensure that illustrations did not mislead purchasers of life insurance, just adding a midpoint scale in addition to the guarantees doesn't cut it in my opinion.

The fifth point concerns inadequate pricing. Has that been a problem historically? Not from a solvency standpoint. Investment problems have been the cruelest bait-and-switch that policyholders have had to deal with, and these problems have more typically been a large company problem. Post-issue adjustments to current mortality and expense charges and interest rates are already governed by an ASP on nonguaranteed elements. I don't believe that this type of bait-and-switch technique is a common occurrence in our industry. I think companies value their credibility with their agents too much to play those games.

Another area of concern is that we have chief actuaries, appointed valuation actuaries, and now proposals for illustration actuaries, nonforfeiture actuaries, annuity actuaries, and Guideline XXX actuaries. I have a real concern that the burden on smaller companies is going to become more than they can bear. This problem doesn't often evoke much sympathy from larger company actuaries however.

Another matter involves the term exemption from the lapse-support test, but not the self-support test. The self-support test, although I just learned it involves a zero profit margin, again has the smell of price fixing to me because by a certain point in time, the accumulated policy cash flows are supposed to equal or exceed the cash value available in the contract. I'm not saying that requirement is not reasonable. I certainly don't expect any problems on our own products. Nevertheless, I think it's a requirement that could be construed as anticompetitive. The lapse support test was designed to address the nonguaranteed persistency bonus games played in products that depend, in large part, on early year lapses to fund those later-year bonuses. But the term products offered today, in particular, have nonguaranteed (in many cases) re-entry provisions 10–20 years from now. Illustrating such re-entry is a cruel hoax when you consider that most of the products will be obsolete in that time frame due to tax or reserve or mortality table changes in the interim, for example, 818-C, the deferred acquisition cost (DAC) tax, Guideline XXX, the year 2000 CSO, or whatever might come along.

We will each make a choice on each policy form. At the policy form level, we'll make a choice as to whether a product is to be marketed with or without an illustration. If a product is marginally priced either as to expenses or a profit margin, do we choose this option? Do we choose to market it without an illustration? I can just hear the agents now, "It's so cheap, the company isn't even allowed to illustrate it!" It may be impractical for universal life (UL), but probably not for term insurance. It could be a viable alternative for term products where you're trying to stay in a market with some of the competition out there today.

My next comment relates to the vanishing premium "payback." I guess I'd have to say I'm disappointed that companies haven't defended themselves more vigorously in this whole situation. Maybe the reason is that their agents didn't do the proper job at the point of sale. But if the agent did, and if the agents have a good file, and they've been following up since the point of sale/issue and have communicated properly to their clients the impact of interest rate changes on at least an annual basis, I don't think we would have this problem. I found it fascinating that the agent in the Crown Life case got $40 million for mental anguish.

The goals of the illustration regulation are to protect and educate consumers. I think the regulation succeeds only on the latter point. I do think the regulation will help educate consumers, but I'm not sure that it will protect them. Another goal is to ensure that consumers understand what they're buying and that they're not misled to purchase. I'm not certain, due to the length of the resulting illustrations, that we will reach that goal. Some of the illustrations that I've seen which purport to comply with the new regulation range from six to ten pages. It's unrealistic to think that consumers will read and interpret that much material. Will the industry benefit to the extent that illustrative values are in effect regulated? I don't feel small companies will benefit, and I think that smaller companies' ability to compete will be severely restricted.

I might suggest an alternative for the disciplined current scale, Steve. I've said this to our agents before. If an illustration out-illustrates USAA or Northwestern Mutual, it can't be disciplined. Tom has made some strong comments that indicate that many states will press ahead with this NAIC model. I wonder how much it will be modified at the state-by-state level creating even more confusion and perhaps more expense. Will the illustration regulation truly end up meeting with the kind of reception that XXX has received after all the hoopla? I think it will be interesting to see where we end up with this regulation.

MR. JAMES D. ATKINS: I've been following this issue for about a year now, and I would like to echo a comment that Kevin just made and it's one that I made in other forums as well. I think the restriction on expense allocations in the disciplined current scale is probably one of the key elements that's still not right. The problems that Kevin pointed out are going to be real problems, they're problems that sooner or later will come back to bite every one of us who gets involved in illustrations or who prepares new products for any purpose. The only right answer, in my opinion, is to use marginal expenses.

MS. CARROLL R. HUTCHINSON: This ties in to Kevin Marti's last comment, but I was planning to direct it to Daphne. If you had the opportunity to make two changes in this regulation, other than to defer its enactment, what would those two changes be? Now tying in with Kevin's comments, since you're a member of the California insurance department, could we expect to see those changes in the California version?

MS. BARTLETT: The change I would make would be to scrap it and start over. I think that the actuarial profession is being put at significant risk because of this regulation. I care a great deal about our profession, and I don't want to see us get into trouble. I would like to see the actuarial role be somewhere in a new regulation, but not to the same extent, or to a different extent, from the way it is right now. With respect to what California is going to do, our commissioner agreed to have us oppose the adoption of this regulation in the NAIC. So I think I can say, with a reasonable amount of confidence, that it will not be adopted in California. I would like to try to come up with another regulation that is more to my personal satisfaction, but whether another regulation will get adopted in California is not likely because any regulation that is significantly different from the model is going to raise a great deal of ire.

MR. HARRIS: Donna, I understand you're involved in developing the standardized expense table that's going to impose price fixing on the insurance industry. Would you like to make a comment?

MS. DONNA R. CLAIRE: With that introduction and having read real comments on this illustration on Actuaries Online, I will not comment on that and just answer the question. At this point, I thought of giving up and said, well, let's make it as good as we can, and one thing is they do give the option for this generalized expense table which will at least help small companies somewhat. The SOA at this point has agreed to take on the role of coming up with this table. It still is dependent on fully allocated expenses. It will be similar to the Tillinghast/Milliman & Robertson expense studies currently being done, but that is currently being worked on. It will depend on the actual expenses off of the NAIC database of the majority of companies.

MR. LARRY J. BRUNING: I'm also disappointed in this regulation for many of the reasons mentioned here. It seems that any law coming down now requires that the actuary must certify. It always seems to start with that requirement. Not that I think we should shun our responsibility; I think we all have a responsibility. I guess I'm somewhat disappointed in state regulation. It has been a pet peeve of mine for a long time. We pay a premium tax and I think all of us are familiar with the variations in what we have to deal with at the state level; some are very good, some are very poor. It seems to me the states bear the ultimate responsibility for protecting the consumer. I think the actuarial profession should be intricately involved in assisting them, but I'm not sure the states should put on us the burden of taking care of everything or certifying everything.

I think about the Food and Drug Administration (FDA). Their ultimate goal is to protect the consumer, but I still don't know what riboflavin or a carbohydrate is. There are all kinds of labeling laws that publish information on what I buy. I still eat the food. I have a general trust in what's in there because the FDA approved it, I guess. I don't know what the right answer is, but maybe we need some kind of regulatory body where we just file and if something is proven to be okay, we should be able to get approval, rather than throwing it out to 1,500 other companies who each must certify that, yes, this complies with the law. Again, it's very complex. I don't know what the right answer is, but I don't think we've served the public with this model regulation. I don't think we're going to educate them with it. We get hung up in these complex formulas and expenses and the right mortality to use, but the public isn't going to understand that.

FROM THE FLOOR: Drawing from Daphne's comments, I would submit that the role of the actuary in this illustration regulation is more of a technician than a professional, and I would like to see us going back to a ten-year projection that is certified as reasonable by the actuary. Nothing beyond ten years can be projected except guarantees.

MR. FOLEY: Where were the people that wanted to do that when we were going through the process. Folks, we've been talking about this for a year. We have taken input from anyone and everyone. If we had any sense that we could have had ten-year projections only, if we had any sense that we could have graded interest rates and that it would have gotten any support, believe me, we would have done it. Where were you people when we were developing the model?

MR. MICHAEL E. MATEJA: I'd like to make two observations. I think the litany of shortcomings of the regulation says something about many potential problem areas. So you have to think hard about whether you should put that in a regulation and whether it serves the industry well. And then I would add a postscript to that. This doesn't sound to me like something that you can develop standards for because it's always going to come up short. You're dealing with something that has many shortcomings to begin with, and those standards are always going to be such that the profession as a whole is going to be at great risk because we're going to have standards that try to produce perfection where it's probably not attainable.

MS. LORI A. TRUELOVE: We cater to the smaller life insurance companies and many of those companies don't have actuaries on staff and didn't know what they were being faced with until the model had rolled along to this point in time. Now they're coming to us saying, how can we be heard? They didn't know how to talk to you. Their voices weren't ever heard and they're going to be greatly impacted by this regulation.

MR. FOLEY: I don't know what companies you're talking about, but believe me, we had small-company representation throughout this entire process.

MR. THOMAS NEAL TAYLOR: I'm disappointed with the expense allocation process because it doesn't seem to me to be strong enough and it allows the marginal expenses. It seems to me that if a company's products don't cover all of the expenses through the future years, that company would have no choice but to improve the current rates until they do cover their expenses.

FROM THE FLOOR: I assume that means he doesn't believe in macro pricing, but I think the issue was if you continue to marginally price, at some point all of your old business that was covering your overhead and nonmarginal expenses will be gone.

FROM THE FLOOR: For example, if investment income on capital and surplus is adequate to cover your excess overhead, where's the problem?

FROM THE FLOOR: In that case, there isn't one.

FROM THE FLOOR: But in the case where you have an old block of traditional business that is supporting much of your expenses and if you're pricing newer business on a marginal cost basis, then you have a problem, but I think that was the issue.

MR. MATEJA: All of the discussion about fixed and allocated or marginal expenses would tend to indicate to me that maybe there are many people that just don't understand how this methodology works. Under macro pricing, all fixed expense is covered by definition. It's just the methodology for pricing where it's all reflected in kind of a book of business effort where you identify what the fixed costs are to be covered. Everything else is priced on a margin, and then you look for an optimum return of volume versus profitability. In the end, you know, everything is covered.

FROM THE FLOOR: But you don't unitize it.

MR. MATEJA: You don't necessarily have to unitize it; you can cover it in the methodology. Now how it applies under the terms of this regulation, I would say is a mystery yet to be determined. The safe harbor would, in effect, force you to somehow allocate that overhead. I don't know what happens in terms of the compliance with the regulation and what you're actually pricing for, but the shortcoming that I see in that is this is serious. The industry has just spoken like the 20th century on the verge of stepping into the 21st in terms of its pricing and reflecting what every other industry does in terms of utilizing marginal pricing technology. This is not slight of hand or an effort to be devious about pricing. This is just a realistic approach to dealing with the issue of expenses and the management of a company and to have that to be dashed, legislated, or regulated out of business, to me, is criminal.

FROM THE FLOOR: I think it's important to remember that while this regulation is not perfect, it's not the regulation that any one of us would have written independently. It recognizes many important things. First of all, the life insurance industry is not like any other industry. The transaction is not over when the sale is made; it's a long-term relationship best entered into with an honest disclosure of the company's current ability to provide nonguaranteed elements and the need for some sort of disciplined current scale. There was testimony at the ASB in March of 1995 that basically it was foolish and foolhardy to try and make any bridge between company experience and illustrations because we all knew that illustrations were set based on competition anyway. Well, that was, frankly, unacceptable.

There was also testimony to the fact that we should trust actuarial judgment. Unfortunately, I think it's safe to say that actuaries haven't used that judgment in recent years, so that was unacceptable to the regulators. The disciplined current scale testing, with all its faults, is the inevitable result of that displeasure on the regulators' part and the burden of doing that testing is worth the benefit. Now while I wouldn't have written that regulation, I wish you would consider it. For one thing, it does get rid of, to the best of our ability, lapse support. As I look at products and the changes in illustrations and what has happened since the mid-1980s, I see that interest rates have come down. I also see, in rather straightforward illustrations, that if you look at the difference between an illustration at 11% and an illustration at 8%, you get maybe a difference of three or four or five years in a short pay period. You don't get differences of 30–40 years which was caused by the derivative sort of thing that was put into illustrations called lapse support. Although this regulation is not perfect, it is a great step forward from where we are and if we can get there, then maybe we can all get the perfection in the next step.

MR. HARRIS: Our third speaker, Steve Patzman, has a few comments. Steve has been active in attending many of the NAIC meetings concerning policy illustrations for the last year. Steve is vice president and corporate actuary at USAA Life Insurance Company.

MR. STEPHEN N. PATZMAN: Our first two speakers have covered the proposed regulation well, so I will not address it, but a couple of things have come up in this discussion and at the recent NAIC meetings. You have heard Tom talk about the frustration of getting input to the process. And you have heard industry people voice concern about input into this proposal. Who is responsible? The obvious answer is us. We need to provide input into the SOA, the AAA, and the NAIC working groups that are trying to work on these problems.

I think it behooves us as professionals to provide as much input as we can as early as possible—not at the 11th hour. I know that can be very difficult sometimes. I know I had a hard time getting final versions of the regulation and the ASP. I had to finally call the SOA and AAA to get the most recent version for this meeting.

This means we have to personally get involved and go to our industry groups and ask to be kept informed of these important topics. I believe most small companies are members of some industry group that can provide information. Another important source of information might be your primary reinsurer. Again, maybe the reinsurers can take this task on and make sure that their clients are educated as much as possible as quickly as possible on the important topics like this.

Next, why is all of this happening? I think it has to do with ethics and professionalism. This SOA meeting has had, as its main theme, ethics and professionalism. I believe that this regulation and many of the others that the NAIC is drafting are written because actuaries are not looked upon as being as professional as maybe they should and thus the NAIC has decided to regulate us more. I think in the last 10–15 years, due to some of the things we have done or haven't done with illustrations, the regulators have had to step in with new proposed regulations. I think we have to work on being professional. We, as a group, can make an impact if we work on it. We cannot expect the SOA or the AAA and their committees to do it all for us—we have to be involved before the problems surface.

If you see something wrong you have to do something about it—that's professionalism. We have a number of ways to deal with unethical and unprofessional practice. We have to use these avenues so that we can better control what is going on or we will continue to have the regulators involved and regulating us more and more. If we don't want that (and we have been saying that for years), we need to get involved in the process of creating regulations and laws.

In summary, if we don't monitor our ethical behavior, we can expect more regulation. If you push the envelope to the maximum, we will have the regulators pursuing more aggressive regulations. If we don't like the direction the regulators are going with proposed regulations, we have to provide early feedback and alternatives that address the concerns of the regulators and their concern for the consumer.

FROM THE FLOOR: Just a quick question as a followup to the comment on California. Tom, you alluded to states adopting this fairly quickly. How much tinkering do you think will go on? If you start getting a number of variations, it will be a big issue. Any feel for that?

MR. FOLEY: Regulators on the working group have talked at great length about not tinkering. North Carolina, for example, because of timing issues, has already begun to go through their rule adoption process. They did a little tinkering. In North Dakota, we anticipate adopting it as is. When I talked to the people in Florida, they anticipate adopting it as is. I'm sure Utah is going to adopt it as is. I think there's going to be a significant number of states that will begin, if not this fall, early in 1996, adopting this model and will make every effort to adopt it as is.

FROM THE FLOOR: This has to do with the question of macro pricing and marginal pricing. In the regulation has it been proposed that if you do marginal pricing on some products that it adds up so that all the expenses are being covered. I think there could be a temptation for somebody to marginally price one product, marginally price another product, and it won't add up so that the fixed bucket of expenses that we're talking about is taken care of.

MR. FOLEY: To use marginal expenses, in total, the expenses have to be greater than the industry table.